

To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy¹

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ABSTRACT

Recent decades have witnessed the remarkable rise of a kind of market authority almost as centralized as the state itself – two credit rating agencies, Moody’s and Standard & Poor’s. These agencies derive their influence from two sources. The first is the information content of their ratings. The second is both more profound and vastly more problematic: Ratings are incorporated into financial regulations in the United States and around the world. In this article we clarify the role of credit rating agencies in global capital markets, describe the host of problems that arise when their ratings are given the force of law, and outline the alternatives to the public policy dilemmas created when ratings receive a public imprimatur. We conclude that agencies designated for regulatory purposes should be required to provide more nuanced ratings exposing their perceptual and ideological underpinnings (especially for sovereigns), and facilitating consideration of alternatives to ratings-dependent regulation.

[I]t is annexed to the sovereignty to be judge of what opinions and doctrines are averse, and what conducing, to peace . . .

Thomas Hobbes, *The Leviathan*²

The only legitimate judge of the security policies of a state was, for Thomas Hobbes, the state itself. The economic policies of states, however, have always necessarily been judged by the market, an abstraction universally understood as a collection of decentralized individuals and firms. It is standard, even cliché, to observe that political economy is based on the tension between the centralized authority of the government and the decentralized authority of the market. In this article we explore the public policy answers to a vexing question: How should governments respond when ‘the market’ is no longer decentralized?

The post-war years have witnessed the remarkable rise of a kind of market-based authority that is almost as centralized as the state

itself – two credit rating agencies, Moody's and Standard & Poor's, which are based in New York but have an increasingly global reach. Through their 'opinions' on the creditworthiness of debt issuers, including sovereign governments, and the default risk associated with their bonds, rating agencies exercise significant and increasing influence over private capital movements (see Sinclair 2005). No sovereign government would dare to issue debt without being rated by one or both of the agencies. In fact, many sovereign governments have, without any intention of issuing debt, sought a rating as a signal of transparency and orthodoxy to the market and other governments.

The influence of the rating agencies has two sources. The first is simply the information content of their ratings, which is a combination of what Hall and Biersteker (2002a) describe as normative market authority and the moral authority of the non-state, non-self interested referee. The agencies' assessments of the likelihood of default thus derive, to a significant degree, from their objective analysis of the risks associated with a collection of macroeconomic policies before the backdrop of their subjective interpretation of the reigning orthodoxy. This first source of power is increasingly well understood by those who analyze the emergence of 'private authority' in the world economy (Cutler, Haufler, and Porter 1999; Hall and Biersteker 2002b). The agencies' sovereign ratings indirectly affect every other bond rating in the world because of the so-called 'sovereign ceiling'. With rare exceptions, private-sector issuers of debt cannot have foreign-currency credit ratings higher than their sovereign's (Abdelal and Bruner 2005a: 6–7).

The second source of the rating agencies' power is both more profound and vastly more problematic: Ratings are incorporated into financial regulations in the United States, as well as in many other countries around the world. A small number of rating agencies are literally, and legally, the 'gatekeepers' to the vast U.S. investing public. The U.S. government thus has put these unregulated firms in the position to express their interpretation of good economic policy to sovereign governments through the process of rating them, and the sovereigns are obliged to listen. EU countries have been on the receiving end of such policy dictates, and European parliamentarians have grown resentful of the perceived lack of understanding that the U.S.-based agencies have shown toward differing accounting standards and corporate financing customs. Ideas under consideration, on both sides of the Atlantic, include two opposite paths – regulating the rating agencies or eliminating the regulatory use of credit ratings altogether. Few policy makers seem to prefer the *status quo* of making unregulated firms so fundamental to the financial regulations that govern trillions of dollars worth of investments.

The codification of this private authority has proven to be, at a minimum, politically and socially unpalatable.

At the very moment that regulators in the United States and Europe have undertaken investigations into the ratings industry, reevaluating whether regulatory reliance on their opinions is either prudent or politically sustainable, G10 central bankers and finance ministers have been busy finalizing a vast extension of ratings-dependent codes through the new capital adequacy rules for banks called 'Basel II'. Revisions of national laws may be undoing the codification of the agencies' influence just as the new international standards for banking are poised to magnify the effects of credit ratings. These contradictory drives underscore that notwithstanding the practical and normative issues associated with regulatory reliance on credit ratings, abandoning them is another matter entirely.

Thus, the 'private' authority of the rating agencies is not so private after all. Governments have both valorized and codified their authority. Indeed, governments define the market for ratings and help to determine their influence. As John Ruggie observes, the scholarly literature has overstated the process of regulatory privatization, 'obscuring the fundamental fact that in many instances of "private governance" there has been no actual shift away from public to private sectors'. Instead, Ruggie observes, 'firms have created a new world of transaction flows that did not exist previously', and which could not have come into being without a new 'global public domain' of transnational discourse (Ruggie 2004, 503–504). This is true for the bond markets, which are based, argues David Beers, Standard & Poor's Global Head of Sovereign Ratings, on a 'common language of credit risk that we at S&P helped to invent' (quoted in Abdelal and Bruner 2005a, 1). The agencies created a new way to talk about credit risk. Investors adopted it as a simple code through which to describe and grapple with the uncertainties inherent in investment. Regulators saw the agencies' analysis as a straightforward, putatively objective framework for the regulation of financial institutions' exposure to credit risk. And issuers came to see the agencies as points of access to international capital flows. But all of this happened not because Moody's and Standard & Poor's usurped the authority of states; instead, the agencies created something new, and governments consented both implicitly and explicitly.

In this paper we seek to clarify the role of credit rating agencies in national and international capital markets, and to describe the host of problems that arise when their ratings are given the force of law through incorporation into financial and prudential regulation. We argue that given the degree of reliance the markets and regulators place on credit ratings, and the lack of clarity regarding workable market-based

alternatives, a more measured approach to these problems should be crafted and pursued, in place of the extreme responses currently receiving attention. Agencies designated for regulatory purposes in the United States (and elsewhere) should be required to provide ratings in a more nuanced format that permits users to distinguish, to the extent possible, between so-called 'quantitative' aspects based on fundamental economic analysis and so-called 'qualitative' aspects flowing more directly from the analyst's perception and ideology. By augmenting the informational value of ratings rather than abandoning them wholesale, a number of practical and normative issues can be managed while longer-term alternatives to ratings-dependent regulation are identified and evaluated.

Credit ratings and private capital flows

While various precursor institutions of the 19th Century provided industrial reports and even information on the creditworthiness of particular businesses, credit 'ratings' as such were an innovation of the early 20th Century, and specifically a response to modern industry and its massive appetite for private capital. The precursors of today's Moody's and Standard & Poor's initially issued ratings solely for the debt obligations of the railroads, which had catalyzed the development of a global bond market to finance their expansion (Sylla 2002: 19).

Throughout their histories, the major credit rating agencies' fortunes have risen, fallen, and risen again in tandem with private capital flows – initially within the United States, and later globally. From their origin in 1909 until about 1930, as Richard Sylla has observed, the agencies grew as the bond market expanded from railroad bonds to include issues by utilities, manufacturers, and sovereign governments. Investors used ratings to sift through the growing number of issues, and the agencies were largely thought to have performed well, endeavoring to establish and maintain strong reputations in a competitive environment through ratings sold to subscribers (Sylla 2002: 33–34). After World War II, however, the agencies declined in inverse proportion to growing economic stability. By the early 1970s the agencies employed few ratings analysts and depended on research reports for revenues (Partnoy 1999: 646–647).

The agencies' spectacular expansion since the 1970s has, again, effectively mirrored the growth in private capital flows over recent decades. Among the issuers that have taken part in the rapid expansion of the global bond market are a growing number of sovereign governments. The agencies have depended, perhaps paradoxically, on some instability in sovereign bond markets: Crises and defaults increase the

potential value to investors of the agencies' expertise at the same time that they threaten to dry up the market or expose agencies to criticism.

Demand for sovereign credit ratings – particularly for high-yield, speculative-grade emerging-market bonds – has increased substantially since the early 1990s, when so-called 'Brady bonds' (essentially defaulted emerging-market bank debt repackaged as bonds) 'whetted investor appetites for high-yielding emerging markets securities, just as developing countries coming out of their 1980s recessions sought lower-cost, longer-term alternatives to bank loans' (Murphy 2000). Standard & Poor's, for instance, rated 30 sovereigns as of 1990, virtually all of which were investment grade, but by early 1998 that number had grown to 74 with an increasing number of speculative grade sovereigns, and by March 2004 had reached 100 with the help of a UN-funded program to introduce sovereign ratings to sub-Saharan Africa (Chambers and Beers 1999; Beers 2004; S&P 2004). Moody's issued 65 first-time sovereign ratings between 1991 and 2002 to reach a total of 100 rated sovereigns (Levey and Komanovskaya 2002). This trend reflects the fact that sovereigns in some instances seek ratings not because they contemplate debt issuances, but in order to communicate their commitment to transparency and efforts to achieve stability, and thereby (hopefully) to gain 'stamps of approval' from international capital markets (Vandemoortele 2004; also see Beers 2004).

The changing business model of rating agencies

The business model adopted by the rating agencies over recent decades differs markedly from that in the period of their origin, as does their position in today's capital markets. Whereas credit ratings initially were financed through subscription fees paid by investors, the dominant rating agencies today derive their revenues principally from issuer fees, creating an inherent conflict of interest that is only exacerbated, according to the agencies' critics, by the extension of the ratings franchise to the provision of ancillary services (Morgenson 2005; *Economist* 2005a; *Economist* 2005b). The agencies claim (very plausibly) that given the non-excludability problem reflecting the 'public good' nature of the product, issuer fees (which in any event can be passed on to investors through lower returns) are the only way to make credit rating a viable business (Partnoy 1999, 653). Even reluctant issuers will likely choose to pay for a rating – regardless of whether they wanted it – in order to have 'the opportunity provided by the formal ratings process to put their best case before the agencies' (Cantor and Packer 1995, 15). The potential for abuse is obvious, and the agencies have sought to defuse criticisms through various internal processes and procedures, including merit-based pay for

analysts and ‘firewalls’ separating them from consulting work and fee negotiations, asserting that reputational concerns are sufficient to check such temptations (Smith and Walter 2002, 289; SEC 2003a; *Economist* 2005a; *Economist* 2005b).

A more fundamental difference in the ratings industry, however, has resulted from financial disintermediation, and the increasingly central role that a small number of prominent rating agencies have come to play in capital markets as they step into the information-gathering role previously played by banks. Traditionally banks have taken in money from depositors (the banks’ creditors), and then lent it to borrowers based on their own credit evaluations, and at their own risk. Since the 1980s, however, banks have been marginalized from this process as depositors have put their money elsewhere and borrowers have found other sources of capital (mutual funds, for instance). As banks have retooled to become ‘active market participant[s]’, rating agencies have stepped in as informational intermediaries between those investing and those seeking capital, giving them substantial influence over private capital flows (Sinclair 1994, 448, 451; also see Sinclair 2001).

Finally, today’s ratings business differs markedly as a result of the incorporation of credit ratings into financial and prudential regulations, both in the United States and elsewhere. While regulators in the United States have used credit ratings as benchmarks for limiting exposure to credit risk since the early 1930s, such regulatory use of ratings has greatly expanded in scope and significance since the SEC coined the concept of ‘nationally recognized statistical rating organizations’, or NRSROs, in 1975 (BIS 2000, 54; SEC 2003a, 5–6). Effectively the SEC has recognized a small number of prominent rating agencies as NRSROs based, among other things, on their having been ‘nationally recognized’ in the United States as issuers of ‘credible and reliable ratings by the predominant users of securities ratings’, permitting financial institutions to count such ratings toward compliance with the wide range of regulations incorporating the concept (SEC 2003a, 6, 9–10). (As of March 2005, the five NRSROs were Moody’s, Standard & Poor’s, Fitch, Dominion Bond Rating Service Ltd., and A.M. Best Company, Inc.) Similarly, the finance ministers and central bankers of the G10 have, in part, built their revised capital adequacy rules, ‘Basel II’, upon credit ratings. In effect, banks not in a position to undertake internal credit assessments (generally those with simpler loans and less sophisticated control structures) may opt to comply with capital reserve requirements based on ratings issued by so-called ‘external credit assessment institutions’, or ECAIs, identified by national supervisors based on criteria roughly similar to the NRSRO designation criteria (BIS 2004a; BIS 2004b, 23).

The ratings marketplace

The market for credit ratings might best be characterized as a duopoly-plus-one (Smith and Walter 2002, 302). Moody's and Standard & Poor's, often called the 'Big Two', issue credit ratings on approximately U.S.\$30 trillion worth of securities each (King and Sinclair 2003, 347; Moody's Corporation 2003, 4). In the 1990s, as demand for sovereign ratings increased, both agencies established cooperative relationships with numerous agencies in the developing world, and by the end of the 1990s, the Big Two accounted for 90% of the sovereign ratings market (Murphy 2000; Partnoy 1999, 650). Fitch is effectively a 'distant third' with some potential to achieve substantial market share, but presently lacks the coverage and reputation to compete with the Big Two (King and Sinclair 2003, 347). Numerous smaller players throughout the world are thought to bring the total to approximately 130 to 150 credit rating agencies worldwide (BIS 2000, 14–15).

While the Big Two emphasize their reputations and investor confidence in their ratings, characterizing the market as a competitive one in which issuers and users of ratings have simply voted with their feet, Fitch has emphasized 'Moody's and S&P's power in the current market', charging that they constitute 'a dual monopoly, each possessing separate monopoly power in a market that has grown to demand two ratings', and engaging in anticompetitive practices in areas of relative strength for Fitch such as structured finance (O'Neill 2003; Moody's Corporation 2003, 5–6, 28; Brown 2003). Indeed, some have argued that the incorporation of ratings into financial regulation has so altered the marketplace that the major incumbents effectively no longer rely on their reputations with investors. The 'regulatory license' hypothesis, as put forth by Frank Partnoy, posits that 'credit ratings are valuable, not because they contain valuable information, but because they grant 'regulatory licenses' vouchsafing compliance. As a consequence, it is argued, the major players flourish not because they enjoy strong reputations in the marketplace, but because ratings-dependent regulation creates artificial demand for their products, as evidenced by market characteristics like the small number of dominant agencies and issuer-based fee structures (Partnoy 1999, 651–654, 681–682; also see White 2002; Kerwer 2002).

The ontology of credit ratings

Given the degree to which investors, banks, other financial institutions, and their regulators – in fact, the entire global financial system – have come to rely on credit ratings to address information asymmetries in the

marketplace, ‘greasing the wheels of capitalism’ by permitting investors to part with their money more comfortably, there is a surprising lack of awareness regarding what it is rating agencies actually do, and how they do it (Sinclair 1999, 161).

The sovereign credit rating process for each of the Big Two is built around the ‘rating committee’, typically comprised of managing directors and analysts of varying backgrounds and levels of expertise (Beers and Cavanaugh 2004; Hilderman 1999). Both Moody’s and Standard & Poor’s look to a number of economic and political criteria broadly indicative of ‘willingness’ and ‘ability’ to repay debt obligations, while emphasizing the centrality of ‘qualitative’ (i.e., subjective) judgment and the lack of any strict methodology (Beers and Cavanaugh 2004; Hilderman 1999, 1, 3; Pinkes 1997, 3; Truglia 1999, 61–62). The ratings themselves, assigned both to issuers and issues, are basically letter grades establishing a relative hierarchy of creditworthiness.³ Typically a first-time rating, once determined by the committee, is communicated to the issuer, which may choose not to make it public, though there are significant exceptions to this general rule (e.g., issuances into the U.S. market) (Murray 1999, 3–4).

Standard & Poor’s rating process is broadly representative. Once a sovereign seeking a rating has entered a formal agreement with Standard & Poor’s and forwarded preliminary economic and financial data, a team of two or more analysts visits the country for three to four days to meet with finance ministry and central bank representatives (including top officials), as well as a range of constituencies outside the government thought to be knowledgeable on politics and economic policy. The analysts then prepare for the rating committee a report including a suggested rating and rationale, which the committee assesses through a number of quantitative and qualitative lenses representative of ‘economic risk’ (the sovereign’s ability to repay) and ‘political risk’ (the sovereign’s willingness to repay). There is ‘no exact formula’ through which such considerations factor into the eventual rating (see Abdelal and Bruner 2005b).

Actual committee discussion remains the ‘invisible ingredient in the ratings process’ across the agencies, though reportedly it ‘often center[s] around intangible issues such as a government’s propensity for ‘orthodox’ vs. ‘heterodox’ policy responses when under acute debt-service pressure’. It is thought that the ‘heavy workload . . . may result in an element of piggybacking’ on the work of other institutions, including ‘the IMF, academia, investment banks, and – conceivably – other rating agencies’, and ‘key inputs’ in the analysis of domestic politics include the likes of ‘the Economist Intelligence Unit’s *Country Reports* and *Country Profiles*, Transparency International’s *Corruption Perceptions Index*,

and Freedom House's list of 'true democracies' (Bhatia 2002, 15, 26–27, 45).

Given the highly subjective nature of credit rating – especially with sovereigns, for which politics and willingness to repay are of special concern (Beers and Cavanaugh 2004; Truglia, Levey, and Mahoney 1995, 4–5) – it follows that the process is permeated by ideologically conditioned judgments. Numerous observers, particularly those from outside the United States, have argued that despite their objective posture, the major agencies' credit ratings reflect a U.S.-centric, liberalist ideology (Murphy 2000; Kerwer 2002, 43; Sinclair 1994, 454–455; Subramanian 2002). For instance, while a sovereign rating will inevitably reflect the analyst's general perception of political stability and institutional transparency, Standard & Poor's looks more specifically at whether governmental 'separation of powers' and 'civil institutions, particularly an independent press', have developed such that 'policy errors' can be 'identified and corrected' quickly (Beers and Cavanaugh 2004). Standard & Poor's also favors 'a market economy with legally enforceable property rights' as 'less prone to policy error' (Beers and Cavanaugh 2004).

Of course rating agencies are far from unique in permitting their ideological and cultural preconceptions to permeate the transactions in which they engage (Sassen 2002, 99), and in any event, while undoubtedly reflective of a particular ideology, few (at least in the West) will query the general wisdom of encouraging the dispersal of political power, a free and vigorous press, meaningful property rights, and an efficient marketplace. More troubling is the implied litmus test – that countries that have gotten this right will be identifiable because they will not make 'policy errors'. Standard & Poor's description of the sorts of characteristics that are generally observed in countries at various rungs on the ratings ladder begins to illuminate what this might mean. Sovereigns in higher ratings categories tend to exhibit '[o]penness to trade and integration into the global financial system', with economic policies that, in general, are 'cautious, flexible, and market-oriented', indicating that 'orthodox market-oriented economic programs are generally well established'. Lower-rated sovereigns, on the other hand, place 'more restrictions' on trade and investment, and '[o]rthodox economic policies are usually not well established' (Cavanaugh 2003).

The concept of an 'orthodoxy' is certainly evocative, but little in the way of substance is provided beyond affirmation of the liberalist commitment to openness. In essence, 'orthodoxy', as used by Standard & Poor's in its methodological literature, appears simply to be a positive term describing the absence of 'policy errors' associated with a lack of openness. Standard & Poor's emphasis on policy in its ratings, and in other communications to sovereigns, provides some confirmation of this.

Following the Asian financial crisis, Standard & Poor's made eminently clear to bruised emerging markets that their 'policy reactions . . . , more so than any new IMF-led support packages', would be 'key to their credit standing', just as the appropriateness of policies undertaken during the crisis had determined 'the rating actions that Standard & Poor's [had] taken in response to them' (Beers et al. 1998). Malaysia, for instance, did not default, though it pursued the 'less disruptive but still damaging' policy of imposing capital controls, contrary to the preference for openness (Beers et al. 1998; also see Abdelal and Alfaro 2002). The degree to which this actually constituted 'error' remains questionable, and in any event, Standard & Poor's has since backpedaled on the question of capital controls, as has Moody's (Beers and Cavanaugh 2004; Mahoney 1999, 57). The fact remains, however, that whether the judgment was right or wrong, Malaysia's cost of borrowing went up when their sovereign rating was downgraded.

It is not surprising that, in many cases, 'policy errors' can be very difficult to identify with any certainty, and that in such cases they are more or less in the eye of the beholder. Of course Standard & Poor's is not alone; Moody's later conceded that it had 'indulged' in a 'blame the borrower' response to the Asian financial crisis, and observed that 'if the true causes of the crisis have been misdiagnosed, then the prescriptions for remediation may be wrong as well' (Mahoney 1999, 54, 57; Byrne et al. 2000, 64). Predictably, where matters are highly 'qualitative' and 'subjective', as they are with sovereign credit ratings, what is deemed 'policy error' will turn largely on who gets to speak. This is not to suggest that credit ratings are themselves in error all or even much of the time, but rather that the essence of a credit rating lies not so much in what is said, but in who said it. Put differently, the significance of a rating in today's global economy derives not from the ideas or information conveyed so much as from the various social, financial, and legal institutions that favor dominant agencies' opinions by hinging various financial and regulatory consequences on their ratings.

That this is so is supported by a growing body of empirical evidence on determinants and relative timing of sovereign credit ratings. One notable study by Richard Cantor and Frank Packer argued, for instance, that Moody's and Standard & Poor's sovereign ratings 'can be explained by a small number of well-defined' economic variables, 'which the two agencies appear to weigh similarly' (Cantor and Packer 1996, 37, 45). This study also found evidence suggesting that '[a]gency announcements of a change in sovereign risk assessments appear to be preceded by a similar change in the market's assessment of sovereign risk', but that '[c]ontrary to our expectations, . . . market anticipation does not reduce significantly, if at all, the impact of a sovereign rating announcement'

(Cantor and Packer 1996, 45, 48). Put differently, the agencies often simply tell the market what it already knows, and yet their ‘announcements’ continue to have impact. The authors of this study conclude that ‘sovereign ratings effectively summarize and supplement the information contained in macroeconomic indicators’, though it is unclear what this ‘supplement’ might consist of beyond the major agencies’ confirmation (at best) or regurgitation (at worst) of established market perception (Cantor and Packer 1996, 49).

This pattern is most troubling in the days preceding and following a major financial crisis. Joseph Stiglitz, for instance, has argued that ‘excessive liberalization is systematically related to a higher probability of crisis’, and that ‘ideology, rather than science’ has dictated economic development strategies over recent decades (Stiglitz 1999, 253; also see Stiglitz 2000, 1075; Stiglitz 2002, xiv). Stiglitz and colleagues G. Ferri and L.G. Liu have also argued that before and after the Asian financial crisis the ‘rating agencies attached higher weights to their qualitative judgment than they gave to the economic fundamentals’ (Ferri, Liu and Stiglitz 1999, 349). More specifically, they argued that Indonesia, South Korea, Malaysia and Thailand received ratings before the crisis that were ‘consistently higher than the economic fundamentals would warrant’, and ratings following the crisis that ‘dropped much more sharply’ than such fundamentals required. Stiglitz and his colleagues speculated that the agencies had downgraded these sovereigns all the more harshly after the crisis in an effort to ‘protect their reputation capital’, having largely failed to see the crisis coming (Ferri, Liu and Stiglitz 1999, 347, 349, 352–353). Such results, taken together with the empirical data on economic determinants of sovereign ratings, sketch an interesting composite picture. In general, these studies suggest, sovereign ratings summarize basic economic data that the market already possesses. At extreme high and low points of the economic cycle, however, such as the emerging-market euphoria of the mid-1990s and the crash that followed, the agencies’ ‘qualitative’ judgment takes over as they follow the market upward, and then scramble to react when the bottom falls out. Moody’s, in particular, has strenuously objected to these charges (Amin-Salem et al. 1998, 7).

Increasing scrutiny

In most markets none of this would constitute a particularly damaging indictment. Predicting the future is difficult in the extreme, and firms make mistakes. Usually, when firms make very large mistakes, market discipline is unforgiving. Clearly, however, the market for ratings is different. Ratings are incorporated into regulation; right or wrong, they

cannot be ignored by regulated investors. This reality has been brought home to regulators in the United States not, however, by emerging market crises, but by Enron and other spectacular corporate bankruptcies of the new millennium (Sinclair 2003, 155–156; Subramanian 2002). In the wake of such scandals, Congress predictably held hearings on the agencies' role (noting Enron's investment grade status just days before its bankruptcy was announced), and through the Sarbanes-Oxley Act of 2002 instructed the SEC to review the industry. The SEC, which had, in vain, proposed in 1997 that a more structured NRSRO designation process be implemented, requested comments from the public regarding 'the appropriate degree of regulatory oversight that should be applied to credit rating agencies' and whether the NRSRO concept should be modified or eliminated altogether – a move that could entail a wholesale rethinking of the regulation of credit risk (SEC 1997; SEC 2003b). Some, for instance, have argued that something more market-based and objective (e.g., credit spreads) be used to eliminate the problems created by the use of credit ratings (Partnoy 1999, 704), though concerns remain regarding the volatility of market-based measures (Mahoney 2002).

The Big Two actually fell on opposite sides of the NRSRO question, with Standard & Poor's in favor of keeping the concept and Moody's urging that it be eliminated (O'Neill 2003; Corbet 2005; McDaniel 2003; McDaniel 2005). Setting aside the merits of the question, one might have thought that the interests of the Big Two would be identical, given their dominance and widespread demand for two ratings. Moody's has, in fact, quite candidly observed that 'as private, profit-oriented entities', agencies 'will not ignore invitations and inducements to enter markets', but that where, as in the United States, 'growth in demand for ratings is not only due to natural market forces, but due to artificial demand for ratings and rating agencies mandated by regulation', ratings no longer function as opinions to be taken or left by investors, and market discipline is accordingly sacrificed (Pinkes 1997, 1, 3, 5). Standard & Poor's, on the other hand, has taken the view that 'the wholesale withdrawal of the NRSRO concept could be costly to market participants which are subject to such regulations and disruptive to the market' (O'Neill 2003; also see Corbet 2005). The Big Two clearly face a difficult cost-benefit problem. Standard & Poor's position is consistent with recognition of the decrease in revenues that might well result from elimination of the NRSRO concept, while Moody's position is consistent with recognition of the potential for increased scrutiny of the ratings industry – and even direct regulation – already clearly on the minds of Congress and the SEC.

Indeed in February 2005 the U.S. Senate Committee on Banking, Housing, and Urban Affairs (the Senate Banking Committee) convened a hearing on the agencies, noting that they 'wield extraordinary power in

the marketplace', acknowledging the view that the NRSRO concept 'has evolved into a quasi-official stamp of market credibility that acts as a barrier to entry', and expressly seeking to 'address the potential for conflicts in this industry' (Shelby 2005). The SEC has also revived its attempt to clarify the 'NRSRO' concept, introduce procedural transparency and reduce barriers to entry, voting at its March 3, 2005 open meeting to move forward with a new rule proposal that would (among other things) explicitly permit sector-specific NRSRO designation, while retaining the circular market acceptance requirement (Donaldson 2005a; Nazareth 2005).

Numerous references were made in both of these settings to conflicts of interest (see Shelby 2005; Stabenow 2005; Egan 2005; Goldschmid 2005), perhaps reflecting a rational likening of credit rating to financial auditing, an activity similarly rife with potential conflicts (and in which private-sector judgments, incidentally, are similarly ensconced in regulation). At the same time, this preoccupation may reflect the regulator's pragmatic focus on an issue more easily identified, described, and resolved than are the more fundamental problems arising from regulatory incorporation of credit ratings. Many – even the pro-market *Economist* – have advocated additional regulation of the agencies (*Economist* 2005a). As observed by one SEC Commissioner desirous of greater 'diligence' in the agencies' work, however, even if Congress were to grant the SEC broad oversight authority with respect to the agencies, such a regime would likely be 'compromised' by protections afforded the agencies under the First Amendment to the U.S. Constitution (i.e. as nominal journalists), which might 'place the SEC in the same situation that it is in today' (Atkins 2005).⁴ Conflicts of interest, on the other hand – regardless of the efficacy of the agencies' internal policies and procedures to address them, and regardless of the public good rationale for issuer fees – present regulators unable to contemplate abandoning ratings-dependent regulation, and yet unable effectively to regulate the agencies themselves, with an easily grasped alternative problem that is already on the public's mind (see Morgenson 2005; *Economist* 2005a; *Economist* 2005b), and for which a set of recently minted responses (post-Enron) already exists.

The situation elsewhere is complicated by the agencies' perceived lack of cultural awareness. In Asia, the major rating agencies have met fierce resistance, due in large part to a perceived lack of understanding of 'Asian business practices' (Sinclair 2001, 443). The agencies have encountered similar problems with sovereigns, as in Japan where sovereign downgrades have been 'dismissed' as 'nothing but interference' and 'unnecessary meddling' (Sinclair 2003, 154, quoting Financial Services Minister Hakuo Yangisawa) driven by application of the U.S.-based agencies' 'home standards' (Sinclair 2003, 154, quoting

Kurosawa Yoshitaka of Nihon University). Given such views, the move to develop domestic agencies is unsurprising (as is their tendency to rate Asian companies higher than do their foreign counterparts), though their global expansion has been limited, at least in part, by their inability to achieve NRSRO status (Japan Center for International Finance 2001; Harada 2005). In China, meanwhile, regulators have sought to foster industry standards as a means of combating high levels of corruption in the credit ratings business (some '80 pct of credit rating agencies' businesses' reportedly being 'connected to companies seeking banking loans') (XFN News 2004; also see AFX Asia 2005).

European critics have likewise argued that 'Europe doesn't have a major rating agency that would take into account the special characteristics of European accounting or the prevailing differences in financial ratios as they evolved in a bank-based financial system', and sovereigns not amenable to foreign criticism have found themselves in the agencies' cross hairs on important issues of domestic policy (Engelen 2004; Kraemer and Marchand 2002; Sinclair 2003, 151–155). European parliamentarians have increasingly complained about industry concentration, the U.S.-centric orientation of the major agencies, the 'protectionist overtones' of the NRSRO system, and the fact that 'European capital markets are faced with the prospect of an ever-increasing use of rating assessments for business and for regulatory purposes' (European Parliament Committee on Economic and Monetary Affairs 2004, 5–6). A European Parliament report (not adopted by the full Parliament, no doubt to the agencies' relief) blasted the agencies, arguing that 'the predominantly American character of the agencies and of their supervisors (i.e., the SEC and Congress) creates a vast de facto imbalance toward the American side', that Europe needs a regulatory body to oversee the agencies, and that 'the effective duopoly of the two main agencies has to be confronted by means of a possible break-up . . . along lines of specialisation' (European Parliament Committee on Economic and Monetary Affairs 2004, 9–11; also see *The Banker* 2004). While not yet ready to go this far, the European Parliament has directed the European Commission to report back by July 2005 with its views on regulation of the agencies (European Parliament resolution on Role and Methods of Rating Agencies [2003/2081(INI)]). The Commission, in turn, looked to the Committee of European Securities Regulators (CESR) for advice, in response to which the CESR endorsed the voluntary code of conduct published by the International Organisation of Securities Commissions in December 2004. CESR members largely favored a 'wait and see' approach, but concluded that '[s]hould self regulation fail to deliver, there might be a need for statutory regulation' (CESR 2005). In any event, the message is clear. In the words of a German finance official,

Jochen Sanio, the agencies are ‘uncontrolled world powers that are directing global capital flows’ (quoted in Engelen 2004) – a state of affairs that Europe is unwilling to live with in the long run.

Notwithstanding all of these criticisms, however, a number of national governments are perpetuating a striking contradiction. At the same time that legislative and regulatory bodies in the United States and the European Union question the appropriateness of incorporating rating agency opinions into regulation, their own central bankers and finance ministers are embarking on a massive expansion of ratings-dependent regulation in the form of Basel II’s ‘standardised approach’ to bank capital adequacy. The lack of clarity on alternative structures, and the simultaneous criticism of and increasing reliance upon credit ratings, reflect the degree to which governments and investors have grown dependent on these private-sector entities, whose work and role in global capital markets remain, at best, dimly understood.

The ratings business, meanwhile, is as profitable as ever, and presumably can only benefit from the new terrain that Basel II opens to it. Standard & Poor’s was a ‘key growth driver’ in 2003 for McGraw-Hill (the publishing company of which it is a division), bringing in revenue of approximately U.S.\$1.8 billion (over 36% of McGraw-Hill’s revenue) and approximately U.S.\$667.6 million in profit (over 60% of McGraw-Hill’s profit) (McGraw Hill Companies 2003, 27, 32, 42–43). Moody’s also did well in 2003, reporting approximately U.S.\$1.1 billion in revenue (over 90% of consolidated revenue of Moody’s Corporation, the rating agency’s parent), and approximately U.S.\$657.1 million in operating income (over 99% of consolidated operating income) (Moody’s Corporation 2003, 19–20, 69–70). Though the Big Two are ‘reluctant to discuss specific fees charged for ratings’, their fees have been estimated to range from U.S.\$25,000 up to U.S.\$125,000 (or approximately 3–5 basis points on the issue).⁵

Opinions, standards, and rules

It is widely recognized that Standard & Poor’s and Moody’s today wield remarkable power, as ‘gatekeepers’ to capital markets, over sovereign and private issuers alike (Kerwer 2002; Sinclair 1999, 161). And yet ironically, this is incompatible with the agencies’ own views regarding how ratings should be used in arriving at investment decisions. The agencies continually emphasize that a rating is just an ‘opinion’, that it is a relative rather than absolute measure of credit risk, and that as such, a rating is only one of many variables that an investor should consider before arriving at a decision to buy, sell or hold a debt security. In Moody’s view, ‘informed investors who come to their own conclusions

about credit quality make more effective use of ratings in managing financial risk', and 'the probability of default is only one factor that investors legitimately consider in making their decisions to lend' (Turner 1999, 6). This view makes sense enough in the abstract. However, real-world institutional investors whose hands are forced by rating changes across the all-important 'investment grade' line, and sovereigns whose policymaking discretion is greatly curtailed by the need to please foreign, largely unregulated private-sector entities, know better (SEC 2003a; Sinclair 1994; King and Sinclair 2003; European Parliament Committee on Economic and Monetary Affairs 2004; Subramanian 2002).

The difference between the ideal and the reality is the functional difference between 'standards' and 'rules'. The agencies present their ratings as 'opinions' that investors can take or leave. When the SEC in 2003 requested comments on the need to regulate rating agencies, Standard & Poor's emphasized that generating a rating involves 'the forming of opinions about that issuer or security and the broad dissemination of those opinions to the public', activities 'highly akin to those regularly performed by professional journalists' (which characterization opens a strong First Amendment defense against intrusive regulation and civil liability) (O'Neill 2003). Likewise Moody's stressed that 'ratings are predictive opinion forecasts about an uncertain future, not statements of fact' (and on this basis has opposed 'any supervision processes that would impair existing Constitutional, federal or state law protections designed to mitigate our exposure' to subpoenas and litigation) (McDaniel 2003).

Few would contest that ratings originally performed as the agencies describe. Ideally, ratings serve as 'signposts' for investors in vast and complex markets, constituting a simplified vocabulary and conceptual framework through which to talk about credit risk (Kerwer 2002, 43). This is the sense in which rating agencies have been described as 'standard setters'; their ratings opinions, in the aggregate, create a nonbinding 'common understanding of what constitutes credit-worthiness', and in this respect represent 'advice given to many' deriving force from 'the legitimacy of the underlying expertise' (Kerwer 2002, 45). The agencies 'vet and judge practices', thereby 'narrow[ing] the expectations of creditors and debtors to a certain well-understood or transparent set that is shared among themselves' (Sinclair 1999, 161; King and Sinclair 2003, 357–358). The check on the agencies' power, in this ideal scenario, is the need to preserve their reputations. That is, they are permitted to play this standard setting role only to the degree that they have earned investors' trust through performance of their ratings over time as predictors of default.

This balance is thrown off, however, when the ‘standards’ become ‘rules’, as when legislative and regulatory bodies incorporate them into regulations, imbuing them with the force of law. Regulatory use of ratings compromises the exertion of market discipline upon rating agencies both directly and indirectly. First, market discipline is reduced directly through the creation of artificial demand for the ratings of designated agencies as investors seek to satisfy regulatory requirements. (While the empirical evidence on this point is mixed [Steiner and Heinke 2001, 139; Cantor and Packer 1997, 1409], Moody’s itself acknowledges this to be the case [Pinkes 1997, 1].) When regulatory compliance hinges on credit ratings, regulated investors have no option but to follow them (Kerwer 2002, 45; Partnoy 1999, 684). Second, market discipline is reduced indirectly to the extent that agency designation requirements for ratings-dependent regulation constitute a barrier to entry into the ratings market, insulating incumbents from potential competitors (Kerwer 2002, 45; Partnoy 1999, 710). Both Moody’s and Standard & Poor’s have in fact expressed support for a more transparent NRSRO designation process, though this may simply reflect confidence that their near total market dominance is effectively unassailable, and/or recognition that in light of the danger of substantive regulation of agencies, the added competition of a few more NRSROs is the least of their worries (O’Neill 2003; McDaniel 2003).

Private actors and public power

This dynamic of private-sector actors wielding *de facto* government power is neither new nor unique. An extensive body of scholarship has examined, for instance, the various roles that ‘networks of knowledge-based experts’, sometimes called ‘epistemic communities’, have played in policymaking, particularly with respect to conditioning ‘the manner in which problems are understood by the policymakers or are represented by those to whom they turn for advice under conditions of uncertainty’ (Haas 1992, 2–3). The ‘epistemic’ concept has been employed to explain ‘the authority exercised by [rating] agencies and its relationship to knowledge’, the point being, as Timothy Sinclair (1999) puts it, that ‘they do not seek to persuade, but to make judgments’. While in theory this ‘epistemic authority’ to judge rests on market perception, and thus could be lost if the market turned on them, such authority ‘is, by its very nature, hard to budge, as others are likely to discount the ‘mistakes’ or epistemic failures of the agencies, given their stock of eminence’ (Sinclair 1999, 159).

A key difference, however, between the ‘epistemic community’ as traditionally conceptualized, and credit rating agencies, is that the epistemic community tends more to inform and influence policy decisions

that ultimately are taken by government officials, whereas rating agencies have effectively been deputized to make decisions themselves that have direct policy consequences. Perhaps a more apt theoretical approach would be that of so-called ‘coordination service firms’ – that is, ‘firms that operate to coordinate the behaviour of other firms’, of which additional examples would include ‘multinational law, accounting, management, and insurance firms, stock exchanges . . . and financial clearinghouses’ (Cutler 2002, 28; also see Sinclair 1999, 153, 161). However, this concept similarly fails to illuminate the dynamics of regulatory infusion of public power into erstwhile private-sector judgments (even though this phenomenon may manifest itself through a number of types of coordination service firms). Crucially, when a rating agency downgrades a security to speculative grade, the agency has effectively commanded certain regulated investors to sell. And when an agency revises its methodology to judge and characterize credit risk in a new way, this decision is essentially given automatic effect through pre-existing regulatory recognition.

While rating agencies may have initially gained prominence as purveyors of expert knowledge, the current degree of authority they exercise over the flow of global capital reflects, to some degree, the changing regulatory role of domestic governments in an age of financial globalization. The rating agencies’ relationship with sovereigns is not best understood in terms of relative power – which they have gained and lost. Rather, this aspect of what Ruggie calls the ‘global public domain’ is wholly new. Governments – particularly the U.S. government, but also the G10 representatives meeting in Basel – have deputized the rating agencies. Public authority has not been privatized. Indeed, it is just the reverse: Private authority that emerged spontaneously, and which previously had no public counterpart, has been given public standing through laws and codes.

That powerful sovereigns like the United States have not exercised direct authority in the market is therefore not an accommodation of the inevitable. These were decisions, often made with a purpose. It undoubtedly remains true that ‘governments routinely obfuscate their final authority in financial markets’ in an ‘intentional effort to render opaque political responsibility’ for difficult decisions (Pauly 2002, 77). There are at least two ways in which declining to undertake direct market regulation through the use of ratings-dependent rules benefits U.S. policymakers. First, increased latitude for private-sector actors to pursue international transactions freely has meant the dissemination of U.S.-centric standards globally. New York-based Moody’s and Standard & Poor’s are, ironically, in a position to tell other governments what to do and how to conduct their economic policies in a blunt vocabulary

unavailable to the U.S. government. These private-sector injunctions are lent far greater force when incorporated into regulations, forcing U.S. institutional investors to act upon the agencies' assessments of the policies pursued by other sovereigns, withdrawing funds (and raising the cost of borrowing) when those policies are frowned upon. Second, the use of credit ratings in financial and other regulations permits policymakers to distance themselves from domestic political fallout when the regulation of credit risk goes awry. When Enron collapsed with no warning from the rating agencies, capping a series of perceived failures including several global financial crises in the 1990s, Congress and the SEC could call hearings, investigate, and berate the agencies, querying whether ratings-dependent regulation makes sense in the future, without digging too deeply into whether incorporating them in the past was simply a bad decision in the first place (SEC 2003a).

This disjuncture between authority and responsibility creates what Dieter Kerwer (2002, 43) has called an 'accountability gap'. Ratings opinions are characterized by the agencies as standards, which the user can take or leave. The user is responsible, however, 'since per definition the adoption of a standard is voluntary' (Kerwer 2002, 45). When a standard is given the force of law through government enforcement, however, the standard setter arguably should be treated as a rule setter, with full accountability for what has effectively become a rule. When this does not happen, 'the standard setter acquires power by third-party enforcement, which is not checked by corresponding accountability' – hence the gap (Kerwer 2002, 46). It should also be observed, however, that deputizing a standard setter in this way creates a corresponding 'accountability gap' in government as well. Policymakers get to make rules, but dodge responsibility for them, by piggy-backing on the decisions of others, whom they can blame when things go wrong. Congress and the SEC cannot be held accountable because they are not the author of the rule content, only the rule framework; they relied on the 'experts' to get the substance right (Kerwer 2002, 45–46). Likewise, the rating agencies cannot be held accountable because while they may have authored the content, they never asked to have a rule framework built around it; they are purveyors of 'opinion', self-proclaimed journalists with a ready made First Amendment defense against civil liability and regulatory intrusion into their operations.

Dealing with uncertainty

To be sure, regulating something as abstract as credit risk exposure is far from straightforward. Whereas policymakers encounter forms of uncertainty in the process of arriving at all kinds of concrete policy initiatives,

in the case of credit risk, uncertainty is the very object of policy itself. Obviously investment, and regulation thereof, are inherently forward looking, and therefore uncertain. While investment is greatly facilitated by the reduction of uncertainty, however, it cannot be eliminated; Moody's itself has stressed that for 'ratings and credit analysis to be effective indicators of risk, markets must operate so that investors really are at risk of loss, and know it' (Turner 1999, 1). This is not really the fundamental problem, however, because even if investors understand that there is an inherent remainder of uncertainty in any measure of credit risk (which must be true, or it would not be risk), they generally still assume that the basis for credit ratings is fundamentally sound and meaningful. This capacity to view a complex world through a simple set of comparative symbols is the rating agency's stock in trade – it is what a rating agency sells to investors (or at least used to, in the days of subscription-based fees). It is crucial to observe that the apparent reduction of complexity through credit ratings both conveys information and elides it. Whatever information a credit rating may convey to the market, it also undoubtedly permits semi-willful ignorance of the full measure of uncertainty inherent in investment. To the extent that credit ratings' 'very existence increases the investors' risk appetite' – based at least in part on faith in the process of their production – the agencies are 'absorbing uncertainty for investors, making unpleasant surprises about credit risk more likely' (Kerwer 2002, 43). For agencies to criticize investors for 'accept[ing] the rating symbol as an absolute value and apply[ing] it as an investment criteria without questioning the rationale' (Turner 1999, 4) is perhaps hypocritical when – setting aside the wisdom of doing so – the very selling point of the letter-grade system is the economy of thought it invites.

The simplicity of the letter-grade system is likewise undoubtedly the root of its attractiveness as a regulatory tool, as evidenced by extensive use in the United States through the NRSRO concept, and its recent incorporation into worldwide prudential regulation of banks through the Basel II framework. Couple this with the dual-incentive for U.S. policymakers to dodge political accountability for the regulation of credit risk, while augmenting the capacity of private-sector institutions to enforce U.S.-centric governance norms abroad, and the pull of credit ratings as a regulatory tool is all but inescapable.

Thus, the government and the agencies appear to have come to a tacit understanding, which is increasingly under threat. Rating agencies get rule-like enforcement of their nominal standards, the accompanying market demand for their product, insulation from methodological scrutiny (through the absence of direct regulation), and a shield from civil liability (through the absence of any serious challenge to their status as

nominal First Amendment ‘journalists’). In exchange, the agencies offer themselves as a repository for residual uncertainty associated with credit risk (that might otherwise temper investor confidence and expose policymakers to the discipline of democratic accountability), accept (limited) reputational liability when things go wrong, and enforce an implicit U.S.-centric, neo-liberal ideology around the world (upon private and sovereign issuers alike) as gatekeepers to the U.S. investing public. This unspoken *quid pro quo* depends on the dissociation of power and accountability, and the dissociation of reputation and market demand. Both result in large part from the incorporation of credit ratings into regulation.

Conclusions: Opening up the ratings

We have identified at least three serious drawbacks of the current relationship between public and private authority in the bond markets. First, sovereign governments, particularly in emerging markets, have seen their policy making discretion curtailed as affluent countries’ regulators decline to undertake direct financial and prudential regulation, effectively augmenting the authority of unaccountable firms to define – or at least reproduce – the terms of orthodox economic policy making. Second, non-sovereign issuers of debt effectively must, like sovereigns, seek out ratings from an artificially narrowed set of dominant agencies in order to tap international capital flows. Third, regulated investors, and the fund managers acting on their behalf, are being forced by the codification of the rating agencies’ role in the markets to adjust their portfolios based on judgments that imply a much greater reduction in uncertainty than can really be the case.

These are consequences that flow quite directly from the enforcement of simplistic letter-grade credit ratings through financial and prudential regulatory rules. As an increasing body of critics – private and public sector alike – are recognizing, the costs of such a regulatory approach may well be exceeding the benefits. There are good reasons to think very seriously about reconnecting power with accountability, and reputation with actual market demand.

The most obvious remedies would be either to replace credit ratings in regulation with a more market-based measure, or to keep the credit ratings but regulate the agencies. Both have their advocates and their detractors. Removal of ratings would force regulators to arrive at some alternative measure of credit risk through the typical rule-making process. Presumably the views of various ‘expert’ communities would be solicited and considered in an open and democratic manner, with a final

determination of a more market-based measure settled upon by government itself. The Big Two would be freed from the specter of government regulation of their operations, but also denied the benefit of government-enforced demand for their products. The empirical literature on credit ratings presents a range of options worthy of consideration.⁶ Were the agencies themselves to be regulated, the methodological ‘black box’ – only dimly understood notwithstanding the major agencies’ publications on ratings criteria – would be opened up, its contents scrutinized, the true nature and extent of uncertainty reduction made more clear, and its ideological biases opened for discussion.

To the extent that either or both of these options prove politically or (in the case of agency regulation) legally impossible, a better, simpler, and more realistic near-term solution might be simply to mandate bifurcation of the so-called ‘quantitative’ and ‘qualitative’ aspects of NRSRO credit ratings, while retaining both. In addition to credit ratings as currently issued by the agencies, reflecting the full range of quantitative and qualitative considerations, an additional quantitative-only rating could be issued. While it is undoubtedly true that ‘qualitative and judgmental aspects of analysis are unavoidable even in the interpretation of quantitative indicators’ (Levey 2002, 89), empirical research demonstrating the predictive capacity and, in some circumstances, the superiority, of defined economic ‘fundamentals’ (Cantor and Packer 1996; Ferri, Liu and Stiglitz 1999) suggests that a practical bifurcation could be undertaken.

The normative and practical advantages of such an approach over the *status quo* are substantial. The full benefit of the analyst’s expertise would be retained, while the black box would be opened at least enough to allow users of ratings to discern what a given agency’s conception of the quantitative fundamentals actually is, and how much a given overall rating is affected by the analyst’s unavoidably ideological, qualitative analysis of factors like ‘political risk’ – achievable through simple subtraction, even in the absence of any coherent statement of principles guiding qualitative analysis. This approach sacrifices nothing, as the presently conceived overall rating would be retained, but more information would be provided in the form of greater nuance, in much the same way that it was when numerical modifiers were introduced to differentiate relative credit risk within a letter-grade category (Kliger and Sarig 2000, 2879). Investors would get a more objective picture of an issuer or an issue, plus the overall picture as refracted through the analyst’s perceptions, helping to combat the complacent assumption that uncertainty has been reduced more than it really has, and providing additional information from which to determine absolute – as opposed to relative – credit risk. Sovereigns subject to the agencies’

policy prescriptions would be armed with additional information through which to assess their own economic circumstances, and a more nuanced sense of the agencies' ideological perspectives. Such an approach would also facilitate regulatory consideration of alternatives to ratings-dependent regulation through increased disclosure of the agencies' methodological thinking – and avoid the more obvious political and legal complications associated with regulating the actual substance of agency analysis.⁷

Even the staunchest critics of the rating agencies tend to recognize that identifying the flaws in the present system is far easier than working out solutions. Though the long-term benefits of reducing or eliminating regulatory dependence on credit ratings would be substantial, there is of course a danger of throwing out the baby with the bath water; hasty action could result in settling upon a market-based measure of credit risk that fails to out-perform credit ratings, thereby damaging already fragile investor confidence. A primary virtue of the bifurcated ratings model advocated here is that it is information-augmenting.

At present, movement on these issues remains tentative at best because the stakes are high and the answers are far from obvious. It is time to consider a more gradual approach to reducing regulatory dependence on credit ratings, a goal that might best be achieved by opening up the ratings themselves.

NOTES

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2. Thomas Hobbes, *Leviathan*, edited by Edwin Curley (Indianapolis: Hackett Publishing Company, Inc., 1994) (with variants from the Latin edition of 1668), Pt. II, Chap. xviii, 9, p. 113.
3. Standard & Poor's long-term issuer ratings, for example, include AAA ('extremely strong' capacity to repay); AA ('very strong'); A ('strong'); BBB ('adequate'); BB ('less vulnerable'); B ('more vulnerable'); CCC ('currently vulnerable'); CC ('currently highly-vulnerable'); R ('under regulatory supervision'); SD ('selective default'); D ('default'); and NR ('not rated'). Ratings of BB and below are considered non-investment grade, or 'speculative' grade (S&P 2002).
4. Several SEC Commissioners expressed desire for greater regulatory oversight of credit rating agencies, bemoaning the current lack of statutory authority (Goldschmid 2005; Atkins 2005; Glassman 2005), and Chairman Donaldson later told the Senate Banking Committee that if Congress wanted more than the voluntary framework sought by the NRSROs, it would have to provide such oversight authority (Donaldson 2005b).
5. Standard & Poor's fees have been estimated at U.S.\$25,000 to U.S.\$125,000, 'with the usual fee amount being 0.0325% of the face amount of the issue' for corporate debt issues, while 'Moody's typical charges were understood in 2000 to be approximately 3–5 basis points . . . on the issue amount, with a minimum of \$25,000 and a maximum of \$80,000 (except for complex issues where the charges could run considerably more)', and with 'some discounts . . . available for large, multiple issuers' (Smith and Walter 2002, 302).
6. See, for example, Partnoy (1999, 704) on the use of spreads; Cantor and Packer (1996) on identifying certain economic variables closely associated with sovereign credit ratings; and Ferri, Liu and Stiglitz (1999) on the possibility of measuring the performance of sovereign credit ratings before and after the Asian financial crisis against a specified set of 'economic fundamentals'.

7. This is not to suggest that the agencies would not seek to characterize this proposal as an impermissible intrusion on their activities. However, the agencies may come to see this proposal as the least unattractive among the variety of regulatory activities currently being discussed.

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