

## Summary

The sharp downgrades of structured credit products that followed in the wake of the subprime mortgage crisis and the more recent downgrades accompanying weakened sovereign balance sheets have focused attention on credit rating agencies (CRAs) and their rating methodologies. In part this attention reflects the myriad ways in which ratings drive investment decisions and collateral eligibility standards, even those of central banks. Securities regulations and rules have played a big part in this rating reliance, as well as prudential regulations. This chapter focuses on how well CRAs do their job and whether they inadvertently contribute to financial instability. The chapter specifically focuses on sovereign ratings, given the most recent escalation in sovereign credit risk and the propensity for ratings to affect sovereign debt markets.

Although CRAs have been under a cloud of suspicion following their role in structured credit markets, it should be acknowledged that ratings serve several useful purposes. They aggregate information about the credit quality of borrowers, including sovereign entities, corporations, financial institutions, and their related debt offerings. They thus allow such borrowers to access global and domestic markets and attract investment funds, thereby adding liquidity to markets that would otherwise be illiquid.

The chapter examines the top three CRAs (Fitch Ratings, Moody's Investors Service, and Standard & Poor's) to see whether they serve their various roles effectively and, more specifically, whether they rate sovereign debt accurately. It concludes that CRAs' ratings influence market prices, and that downgrades through the investment-grade barrier trigger market reactions. It shows that their market impact is associated not only with new information, but also with a "certification" role, though this is most evident through their use of "outlooks," "reviews" and "watches" (pre-rating change warnings) rather than actual rating changes.

CRAs insist that they do not target their ratings to specific credit risk metrics, such as default probabilities or expected losses, but only to ordinal rankings of credit risk. Tested against this objective, the chapter finds that the CRAs' discriminatory power of sovereign default risk is validated to some extent. For example, all sovereigns that defaulted since 1975 had noninvestment-grade ratings one year ahead of their default.

Despite the CRAs' goals of delivering only ordinal rankings, ratings are often used as though they map into specific credit-risk metrics, including in the Basel II standardized approach to determining bank capital requirements. Given this important use, and assuming Basel II's reliance on ratings remains, CRAs should provide default probabilities or expected losses. Also, they should be expected to meet the same rating calibration and validation standards as those required of banks that use the Basel II internal-ratings-based approach, since the CRAs are a substitute for this more sophisticated approach.

In addition, to reduce the negative "cliff effects" in prices and spreads that rating changes imply, the chapter recommends that regulations that hardwire buy or sell decisions to ratings be eliminated. This recommendation is already being implemented to some degree in some countries, but could usefully be extended. As well, CRAs should continue to provide additional information on the accuracy of their ratings, the underlying data, and their efforts to mitigate the conflicts of interest that are associated with their "issuer pay" model of charging issuers for their ratings.