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ENDOGENOUS SOURCES OF CONFLICTS OF INTEREST ARISING IN THE ACTIVITIES OF CREDIT RATING AGENCIES

Abstract. The positive effect of the functioning of credit rating agencies (CRAs) increases only if they are focused on maximizing information quality of ratings. Instead, CRAs' reorientation to the maximization of profits in the short term can generate significant negative externalities. One of the key reasons for shifting of outlined focus could be conflicts of interest, generated by the influence of exogenous and endogenous factors. Given that the possibility of rapid and effective reduction of exogenous factors' influence is significantly limited, the study of endogenous sources of conflicts of interest becomes relevant for their further localization and elimination.

The paper identifies that the main endogenous sources of conflicts of interest could be localized both at the corporate, and operational levels of CRAs' functioning. At the corporate level conflicts of interest are usually generated due to the existence of significant pitfalls in the models of ownership, business and financial activities, transparency, corporate governance and organizational structures of CRAs. In turn, at the operational (analyst) level the main sources of conflicts of interest are the violation of the principle of the independence of analysts and other employees of CRAs, as well as their personal interest in the manipulation with ratings.

Taking into account the specifics of outlined endogenous sources in their interconnection will contribute to designing of a comprehensive system of preventive and reactive tools to manage conflicts of interest by the owners, managers, and regulators of CRAs.

Keywords: credit rating agencies; CRAs; conflicts of interest; CRA independence; rating inflation; unsolicited ratings; “subscriber-pays” model

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ЕНДОГЕННІ ДЖЕРЕЛА КОНФЛІКТУ ІНТЕРЕСІВ У ДІЯЛЬНОСТІ КРЕДИТНО-РЕЙТИНГОВИХ АГЕНТСТВ

Анотація. У статті визначені, охарактеризовані та систематизовані ключові ендogenous джерела розгортання конфліктів інтересів як на корпоративному, так і на операційному рівнях функціонування кредитно-рейтингових агентств (КРА). Урахування специфіки окреслених ендogenous джерел у їх взаємозв'язку сприятиме проектуванню комплексної

системи інструментів превентивного та реактивного управління конфліктами інтересів з боку власників, керівників а також регуляторів діяльності КРА.

Ключові слова: кредитно-рейтингові агентства, конфлікт інтересів, незалежність КРА, інфляція рейтингів, ініціативні рейтинги.

Формул: 0; рис.: 1; табл.: 0; бібл.: 20.

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ЭНДОГЕННЫЕ ИСТОЧНИКИ КОНФЛИКТА ИНТЕРЕСОВ В ДЕЯТЕЛЬНОСТИ КРЕДИТНО-РЕЙТИНГОВЫХ АГЕНТСТВ

Аннотация. В статье определены, охарактеризованы и систематизированы ключевые эндогенные источники возникновения конфликтов интересов как на корпоративном, так и на операционном уровнях функционирования кредитно-рейтинговых агентств (КРА). Учет специфики определенных эндогенных источников в их взаимосвязи будет способствовать проектированию комплексной системы инструментов превентивного и реактивного управления конфликтами интересов со стороны владельцев, руководителей а также регуляторов деятельности КРА.

Ключевые слова: кредитно-рейтинговые агентства, конфликт интересов, независимость КРА, инфляция рейтингів, инициативные рейтинги.

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Introduction. The usefulness and importance of functions of credit rating agencies (CRAs), as well as their significant impact on the modern financial markets' efficiency, the trust, and confidence of investors and borrowers, could hardly be overestimated. However, the positive effect of CRAs' functioning as information intermediaries grows only if they focus on maximizing the information quality of rating assessments as the basis for their reputation capital increasing. Instead, the reorientation of CRAs to profits maximizing in the short run, which is usually realized precisely at the expense of ratings' inflation, can generate significant negative externalities. So, Thomas Friedman, a three-time winner of the Pulitzer Prize, said: "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful" [1].

At the same time, among the key reasons for outlined focus shifting in CRAs' activities, researchers traditionally underline conflicts of interest, generated by the influence of exogenous and endogenous factors. Thus, the study of potential conflicts' of interest sources for their further localization and elimination does not lose its relevance.

Recent research review and problem statement. On the basis of previous research we had determined that among the main *exogenous sources* of conflicts of interest in CRAs' activities are (1) *shortcomings in the legislation* (in particular, excessive supervisory and regulatory dependence on credit ratings, poor regulatory support of the procedures for supervision and regulation of CRAs, high regulatory entry barriers, and exemption of CRAs from civil liability); (2) *inefficient licensing, supervision, and regulation of CRAs*, and (3) *a significant level of market concentration*.

However, we share the skepticism of many researchers about the possibility of rapid and effective elimination of outlined exogenous factors' influence. In particular, it is problematic to reduce significantly the supervisory and regulatory dependence on credit ratings. We also agree

with the conclusion of the Basel Committee on Banking Supervision that currently there is no alternative to credit ratings in the area of independent assessment of borrowers' creditworthiness and debt instruments' credit quality.

Regarding the stimulation of CRAs competition, it should be noted, that the entry of new players in the industry may further encourage CRAs not to hold the principle of rating conservatism with the aim of increasing the client base at the expense of debtors interested in obtaining the highest possible credit ratings.

For example, in their empirical work, B. Becker and T. Milbourn [2] show that competition between CRAs after the entry of Fitch Ratings Ltd. (*Fitch*) in a market, previously controlled by a duopoly of Moody's Investors Service, Inc. (*Moody's*) and Standard & Poor's Rating Services (*S&P*), have led to lower quality and informality of bond ratings: rating levels went up, the correlation between ratings and market-implied yields fell, and the ability of ratings to predict default deteriorated.

T. Mählmann [3] by analyzing a large sample of US bond issuers rated by Moody's, S&P and Fitch also determined strong evidence of rating shopping behavior when issuers press Fitch for a better rating. Such behavior was driven by the strategy of lowering the standards applied by Fitch to the assessment of issuers who had received rating coverage from the other agencies.

P. Bolton, X. Freixas, and J. Shapiro [4] argue that monopoly at the rating services market is even more efficient than a duopoly, since the latter gives issuers more opportunities to take advantage of naive investors through rating shopping.

Therefore, in our opinion, the main potential for conflicts' of interest elimination in CRAs' activities is concentrated in improving the tools of preventive and reactive influence on *endogenous sources* of conflicts of interest.

According to the observations of the International Organization of Securities Commissions (*IOSCO*) specialists, conflicts of interest arise mostly because of the existence of flaws in ownership structures, business or financial activities of CRAs, or due to their employees' financial interests. In particular, as a result of [5]:

- 1) having financial interests in rated companies (ownership of shares and other forms of affiliation with the debtors, issuers, and underwriters);
- 2) receiving most of CRAs' revenue from rated companies ("issuer-pays" financial model), that can motivate CRAs to underestimate the level of credit risks in order to gain loyalty of such companies;
- 3) access to nonpublic information that may encourage CRAs' employees to obtain personal benefits from insider trading;
- 4) providing ancillary advisory services that can affect rating decisions;
- 5) issuing of unsolicited ratings [6, 7].

In addition to the above-mentioned IOSCO Reports on the activities of CRAs [6, 7] and the Code of Conduct Fundamentals for Credit Rating Agencies (*IOSCO CRA Code*) [5], a wide range of conflicts' of interest endogenous sources is also implicitly contained in the provisions of legislation in the sphere of CRAs' activities regulation (in particular, EU Regulations № 1060/2009 [8], № 449/2012 [9]), and Regulatory technical standards of the European Securities and Markets Authority (*ESMA*) [10].

For example, ESMA requires CRAs to provide information in order to assess any conflicts of interest arising from (1) activities and business interests of their owners, (2) providing of ancillary services, (3) outsourcing of rating activities, (4) interaction with related third parties; (4) pitfalls in their corporate governance, (5) organizational structures, and (6) their policies and procedures with respect to the identification, management and disclosure of conflicts of interest, and (7) the rules on rating analysts and other persons directly involved in credit rating activities [10].

Thus, as it is fairly observed by L. Bai [11], conflicts' of interest sources could be localized both at the corporate (agency) and operational (analyst) levels of CRAs' functioning. To the main sources at the corporate level, that were outlined earlier, the researcher adds a possibility of the significant destructive influence of large investors (subscribers) on the activities of CRAs.

We also agree with the findings of L. Bai that at the operational level the main potential reasons for analyst's personal interest in overestimating credit ratings are: (1) direct or indirect ownership of securities of rated entities; (2) parallel position or directorship employment at a rated entity; (3) business relation beyond ordinary course of business or special purpose relationship (for example, borrowing money at below market rate from a rated entity, previous employment relationships, family relationships etc.); (4) receipt of gifts from rated entities; and (5) determination of analysts' compensations based on rating fees [11].

Highly appreciating the considerable groundwork of scholars and practitioners, we should note, however, that their studies are to some extent fragmented and primarily focused on the deep study of certain sources of conflicts of interest in CRAs' activities. As a result, in scientific works, endogenous sources of conflicts of interest in CRAs' functioning are structured insufficiently.

The article aims to identify, comprehensively research and systematize the key endogenous sources of conflicts of interest arising both at the corporate and operational levels of CRAs' functioning. It is expected, that results will further contribute to the design of effective tools for preventive and reactive management of such conflicts.

Research results. Exactly the transition from the "subscriber-pays" model (when credit rating services were paid by investors) to receiving most of CRAs' revenue from the rated companies ("issuer-pays" model) is considered by many researchers [3, 11–13] as one of the key catalysts of the conflicts of interest problem. W. Harrington, a former senior president at Moody's, who worked at the agency for 11 years, confirmed, that rating agencies suffer from a conflict of interest because their services "...are paid by the banks and companies they are supposed to rate objectively" [14]. As one of the commentators put it: "It is as if the referee was paid by one of the teams" [15].

The "issuer-pays" financial model may encourage CRAs to focus on maximizing the number, but not always the quality of ratings [12]. Based on the fact that agencies' services are typically paid only if the credit rating is issued, CRAs become more prone to inflate ratings, reduce standards, and otherwise please their customers. Otherwise, clients, unsatisfied with the low rating, could shop around for more favorable assessments from other agencies [4].

Several factors could be identified that cumulatively influenced the situation when the bulk of demand for rating services began to be formed not by investors preoccupied with the objectivity of ratings, but by the rated entities interested in inflation of such assessments. Among them, in particular, are the gradual significant increase in references to credit ratings in rules and regulations (creation of more or less "guaranteed market" for CRAs), the development of photocopying techniques [15] and the transformation of credit ratings into public goods [13].

At the same time, despite the transition of the majority of CRAs to the "issuer-pays" model, agencies could still be *significantly influenced by large investors* who pay subscriber fees for the access to credit rating history or for other credit rating services. For fear of losing such subscription revenue, CRAs may be pressured into issuing an inappropriate rating or slow down rating actions for the benefit of large subscriber clients who also have serious conflicts of interest [11, 12].

In particular, large investors could try to influence a CRA to provide lower initial ratings, which tend to provide higher yields [16]. On the other hand, some institutions might pressure a CRA to assign an investment-grade rating on a particular security because the value of the security holdings or the status of regulatory compliance of such subscribers depends on the ratings of the securities [3, 11, 12, and 16].

Significant preconditions for conflicts' of interest arise also in the case of rating the affiliates. Affiliate, as it is defined by IOSCO [5], means "an entity that directly or indirectly controls, is controlled by, or is under common control with another entity". In the case of direct or indirect ownership of shares of investors, issuers and their agents, CRAs may have financial interests in assigning incorrect ratings or slowing down the rating actions. In other cases of affiliation, rating decisions of CRAs may be taken under the influence of third parties, whose financial interests could depend on the level of the rating assigned.

The majority of CRAs in addition to rating services provides a wide range of *ancillary services*.

Usually, they are in the form of market and economic trends forecasting, pricing analysis and other types of data analysis, advising on debt restructuring, risk management, etc. Such services provision often generates a significant proportion of the CRA's income in addition to income from the main rating business. According to many researchers [7, 11-13], such a situation could serve as a significant endogenous source of conflicts of interest.

Thus, CRAs may assign more favorable ratings for ordering their ancillary services, or vice versa – threaten clients with reduction of ratings if they refuse such an order. Also, in the form of consulting services, issuers can receive “preliminary” ratings from several CRAs simultaneously. That could give them an opportunity to choose among those agencies the one which offers the highest estimation [11]. Such rating shopping significantly distorts the estimates of the real level of credit risk and complicates making objective investment decisions. As R. Monro-Davies, chief executive officer at Fitch, stated it “If you guarantee a ‘triple-A’ [rating] to a company, it becomes more difficult to change your mind afterward” [17].

In addition, CRAs could advise clients on issues connected with developing and efficiently structuring financial instruments in order to afterward obtain from the agency a higher rating of such instruments [13].

The issuance of unsolicited ratings (i.e., ratings published by CRAs without the request of the issuers or their agents), according to the observations of many researchers [7, 11, 12, 18, and 19], may also serve as a source of potential abuses by agencies. Contrary to solicited ratings, unsolicited ones do not imply the payment of a rating fee. So CRAs usually use them as a way of establishing a track record before entering a new market. Agencies also justify their need to assign unsolicited ratings by claiming that there is strong demand for them from financial markets participants [11].

But some academic literature [1, 11, and 19] describes several examples, known from the international practice, when CRAs by using the fact or even only a threat of hostile unsolicited ratings' assignment forced clients to order rating coverage, to buy ancillary services or to pay higher fees.

A well-known case is a conflict between Moody's and the Jefferson County, Colorado, School District No. R-1. In 1993, the school district decided to issue new bonds with lower interest rates. In order to provide a rating coverage, district representatives turned to S&P and Fitch instead of Moody's, with whom they had previously collaborated. In response, Moody's has published and electronically distributed among its clients, subscribers, and news agencies a “negative outlook” for county's bonds, which until that moment had been sold well enough. As a result, several buyers immediately canceled their orders, and the school district was forced to revalue the bonds and pay a higher rate. The cost of issuing the bonds was increased by \$769,000 [1].

Another “textbook” example of conflict of interest in the context of unsolicited ratings' issuance is a series of credit ratings' downgrades of one of the world's largest reinsurance companies – Hannover Re. In 1998, Moody's representatives contacted Hannover Re with a proposal for cooperation but were refused because the company had already hired S&P and AM.Best. In response, over the next five years, Moody's has repeatedly rated Hannover Re on an unsolicited basis, and those ratings were from two to four notches lower than the ratings given by S&P and AM.Best [11]. The final rating downgrade to “junk” status, despite the lack of new public information for its justification, caused a 10 % (\$175 million [19]) drop in the insurer's stock price in just a few hours. Hannover Re's executives argued that this series of downgrades was “pure blackmail”, and that they “...were told on many occasions that their rating would be impacted positively if they subscribed to Moody's service” [18].

It should be noted that, besides the pressure on corporations, CRAs could also use the issuance of unsolicited “hostile” ratings as an instrument of influence on political and economic processes in particular countries. Examples of such cases are often connected with PIIGS countries (Portugal, Italy, Ireland, Greece, and Spain).

As an additional stimulus to conflicts of interest Fulghieri, Strobl, and Xia [19] by using the dynamic rational expectations model of the credit rating process also show that unfavorable unsolicited ratings' issuance creates for CRAs certain reputational benefits by demonstrating to

investors [and supervisory authorities] that they could resist the temptation to issue inflated ratings.

There is also empirical evidence that unsolicited ratings tend to be lower than those requested and paid by issuers or other rated entities [11, 18].

CRA's usually explain this phenomenon as follows:

1) issuers often refuse to cooperate in providing non-public information for the issuance of unsolicited ratings, and, therefore, such CRA's assessments based largely on publicly available data are necessarily more conservative [11];

2) reliable borrowers often request rating coverage voluntarily ("solicitedly"), but unsolicited ratings are usually assigned to lower-quality borrowers who refuse to obtain rating services due to their insufficient creditworthiness.

However, P. Van Roy [18], using an endogenous switching regression model for the analysis of a sample of Asian bank ratings, rejected such hypothesis of better-quality issuers' "self-selection" into the solicited group with higher ratings. However, the researcher confirmed that unsolicited ratings appear to be lower and more conservative because they are based on public information.

In our opinion, at the corporate level, the potential for conflicts of interest increases also due to *the inefficiency of corporate governance, the irrationality of organizational structures, and lack of transparency* in the activities of CRA's.

As an obstacles for efficient prevention, proper identification, elimination or management, and disclosure of conflicts of interest may serve *the absence of independent persons responsible for such functions, auditors of the quality of credit ratings, independent members of the administrative or supervisory board; lack of appropriate policies and procedures, reporting and communication channels for CRA's staff; poor internal records about important stages of the rating process; the opacity of the duties and powers of the responsible persons involved in that process; the violation of the collective decision-making principle on the determination of credit ratings; the absence of the corporate code of conduct and of the compliance obligation with the IOSCO CRA Code.*

In turn, *the lack of public disclosure* of essential aspects of CRA's activities does not allow ratings users draw their own conclusions about the quality of corporate governance and conflicts of interest management of particular CRA. Among such essential aspects are the ownership structure, income sources and tariff policy, actual and potential conflicts of interest, procedures for their identification, elimination and management.

The opacity of procedures and methodology of assigning, updating, suspending, and withdrawing of credit ratings, non-disclosure of ratings history, rating reports, and ratings accuracy statistics significantly complicate for investors and other stakeholders their independent assessment of the credit rating process integrity and the credit ratings' quality of particular CRA.

Thus, *the lack of transparency of CRA's activities* in the above-mentioned aspects does not allow financial markets participants to understand the nature and limitations of credit ratings and the risks of unduly relying on them to reach informed investment or other financial decisions, and also decisions with respect to their cooperation with particular CRA. This reduces for CRA's the disciplinary effect associated with potential reputational losses, which, in turn, aggravates the conflicts of interest problem.

As it was noted, the sources of conflicts of interest could be localized not only at the corporate (agency) level, but also at the level of individual employees (Fig. 1). Former senior president at Moody's W. Harrington claimed that «...this salient conflict of interest permeates all levels of employment, from entry-level analyst to the chairman and chief executive officer of Moody's corporation», and that agency used a long-standing culture of "intimidation and harassment" to persuade its analysts to ensure ratings match those wanted by the agency's clients [14].

If CRA's employees are allowed to invest in securities, this may lead to situations where: (1) inappropriate credit ratings are assigned to issuers in order to favor the trading positions of such employees; (2) employees receive personal benefits from insider trading due to access to confidential information, delays in ratings' publications, and/or early disclosure of future rating changes to third parties.

ESMA experts also point out that the risk of conflicts of interest at the operational level (in particular, due to the leakage of confidential information and the issuer’s influence on CRA’s decision) increases proportionally to the length of time between reaching the rating decision, informing the rated entity (to clarify any factual errors, omissions, or other misperceptions that would have a material effect on the credit rating [5]) and taking a credit rating action (publication of rating) [10].

Consequently, conflicts of interest could exist even if CRA’s analysts do not own securities directly. For example, an analyst may be influenced by colleagues from other departments or from previous jobs, who, in turn, own securities rated by the analyst [11].

The independence of rating analysts and those who accept credit ratings may also be violated by long-term relationships with the same rated entities. There are examples where CRA’s employees simultaneously held senior positions in rated entities, which led to unduly positive ratings that benefit those firms. For example, former chairman of Moody’s Clifford L. Alexander Jr. for nineteen years served on the board of MCI Communications Corp, which was subsequently absorbed by WorldCom Inc. During this period, Moody’s maintained a solid investment-grade rating on WorldCom/MCI even after bond traders were selling WorldCom at “junk” levels [20].

There are also examples where credit rating managers and analysts participated in fee discussions with issuers. In such cases, the professional independence of analysts is violated, and prerequisites for “rating shopping” are created [11, 13].

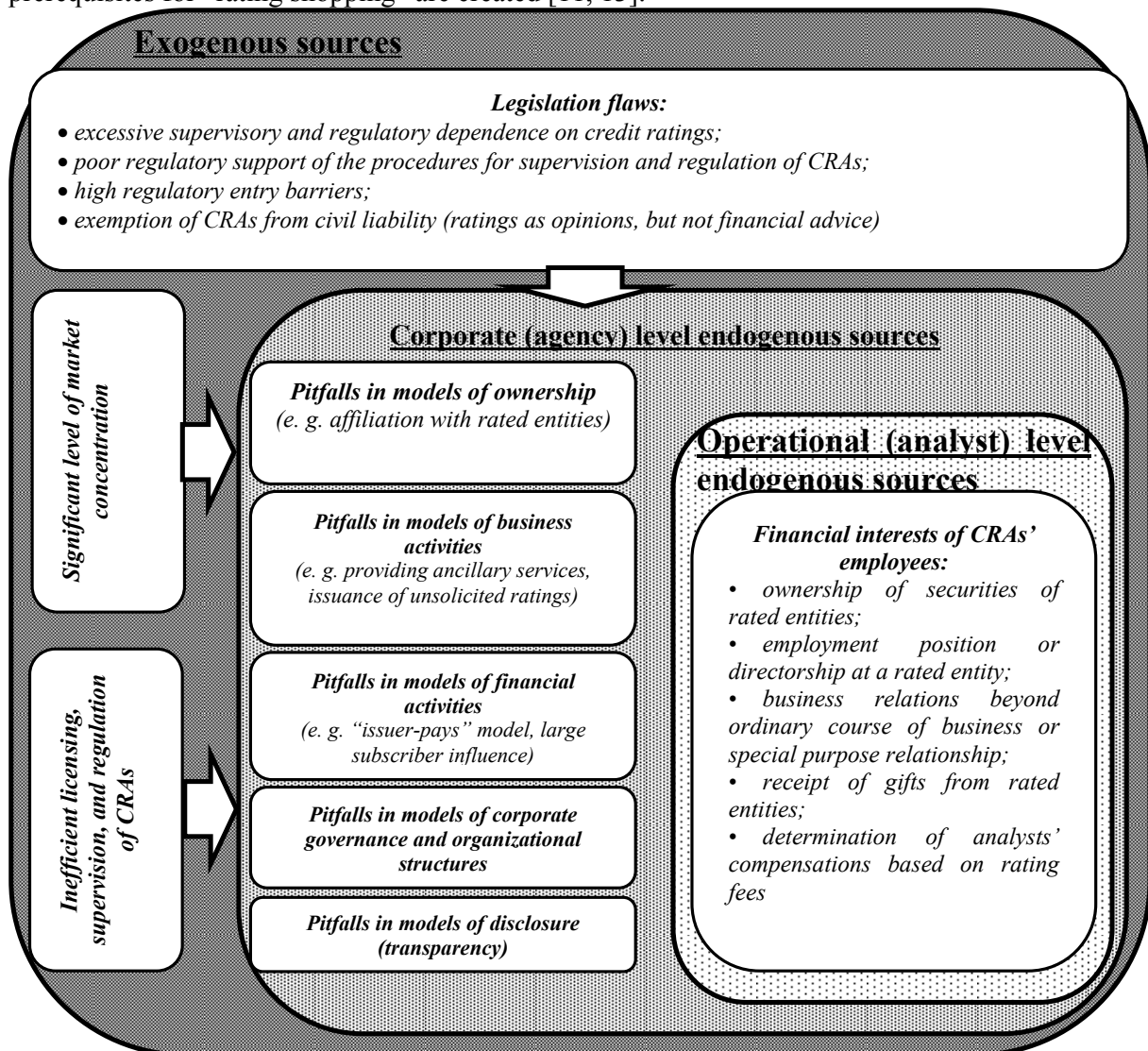


Fig. 1 The main sources of conflicts of interest in the activities of CRAs
Source: results of authors' research

Conclusions. Thus, the main endogenous sources of conflicts of interest could be localized both at the corporate, and operational levels of CRAs' functioning.

At the corporate level conflicts of interest are usually generated due to the existence of significant pitfalls in the models of ownership, business and financial activities, transparency, corporate governance and organizational structures of CRAs. In turn, at the operational (analyst) level the main sources of conflicts of interest are the violation of the principle of the independence of analysts and other employees of CRAs, as well as their personal interest in the manipulation with the timeliness of the rating process.

Taking into account the specifics of outlined endogenous sources in their interconnection, in our opinion, will contribute to the design of comprehensive system of preventive and reactive tools to manage conflicts of interest by the owners, managers, and regulators of CRAs.

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