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Rating Agencies: An Oligopoly?

－Underlying Problems of Disputes on the Ratings of Japanese Government Bonds－

Tadahiro Asami

Managing Director

The Institute for International Monetary Affairs

1. Introduction

Last April, Haruhiko Kuroda, Japan's Vice Minister for International Affairs of the Ministry of Finance sent a letter to three rating agencies [i], (Moody's, S&P and Fitch) expressing his grave concern about the ratings of Japanese government bonds (JGBs), which have been continuously downgraded since 1998. The Vice-Minister of Finance claimed in the letter, that the ratings of JGBs are too low, without a valid foundation, and asked for a clarification of such ratings. It is unusual for a sovereign government to express its discontent to private rating agencies in an open letter.

The objective of this official action is considered to deter any further downgrading by raising public awareness of the rating issue through open discussions. Apparently, the government also fears that further downgrading will slash bond prices and adversely affect ratings of not only government-owned public corporations, but also banks and private companies in general. Furthermore, under the proposed New Basel Capital Accord (Basel Ⅱ), which is expected to become effective at the end of 2006, the risk-weight for A-rated government bonds will be 20%, compared to a zero risk-weight for those rated AA. Thus, the downgrading of JGBs to level A would reduce the capital ratio of Japanese banks that

i The three rating agencies are Moody's Investors Services, Standard & Poor's and Fitch Ratings.

hold a substantial amount of JGBs in their portfolio [ii].

This paper discusses the least competitive mechanism of the rating industry among various financial services industries, the development of rating agencies operating in global markets, the increasingly critical role to be played by them, and the importance of developing a more competitive rating industry. These issues will be considered through analyzing the problems that have come to light through the disputes on JGB ratings between the Japanese Ministry of Finance and the three rating agencies.

2. Disputes on Japanese Government Bond Ratings

Japan's general government debt is 1.4 times its GDP and 4.5 times its recurring revenue. The government will need to continue issuing bonds amounting to more than yen 100 trillion (including refinancing) annually, for at least the coming several years to fill the budgetary deficit. As a result, government debt will continue to increase over the medium-term. The level of government debt has reached a point of grave concern and fiscal reconstruction is one of the top priority policy issues of the government.

The three rating agencies assigned the following ratings to JGBs in their latest assessment.

	Moody's	S&P	Fitch
Foreign currency-denominated bonds	Aa1	AA-	AA
Domestic currency-denominated bonds	A2	AA-	AA

There are discrepancies among the ratings provided by the three rating agencies;

- While S&P and Fitch gave the same rating (Fitch rates AA and S&P rates AA-) to both domestic and foreign currency-denominated government bonds [iii] (including Euro yen bonds), Moody's has a four notch split between the two ratings (Aa1 for foreign, and A2 for domestic currency-denominated bonds).
- There is a maximum three-notch split in the ratings made for domestic currency-denominated government bonds. (AA by Fitch against A2 by Moody's)

The three rating agencies arrived at these different rating assignments, based upon their respective analysis of Japan's economic fundamentals, including fiscal policy and political environment. What kind of difference in interpretation and analytical methodology is attributable to these different results? Rating is a symbol given to a debtor to indicate the medium-term possibility of default, but a detailed explanation for a rating is not generally provided for sovereign ratings. A clear answer explaining the splits has not yet been given by the rating agencies on Japanese sovereign ratings. As far as the open response made by

ii At national discretion, a lower risk weight (in this case zero percent) may be applied to a bank's exposure to domestic currency-denominated sovereign debt.
iii There are no foreign currency-denominated JGBs outstanding, but only government-guaranteed bonds.

Fitch (the only rating agency to disclose its letter) to the Ministry of Finance and other information on websites are concerned, the points raised by the Vice Minister of Finance have not been answered.

There have been a wide range of reactions to the ratings, in particular Moody's rating that gave the lowest level among the three. While some felt and openly voiced their resentment that the ratings did not reflect an accurate picture of the Japanese economy, others felt that these ratings should be considered as a warning to Japan, since they reflect the loss of market confidence in Japan's ability to manage its economy.

The writer's opinion is summarized below.

(1) Since the economic impact of a sovereign rating on the market is significant, rating agencies, which function as public institutions, have the responsibility to explain to the public how they arrived at a particular rating by disclosing, to the extent possible, the basis of their analysis. The letters from the three rating agencies, responding to the Finance Ministry's open letter, should be disclosed to the public to make the rating process more transparent.

(2) Generally, rating for foreign currency-denominated bonds is treated with stricter criteria than for domestic currency-denominated bonds. The rationale behind this is that, in the case of domestic currency-denominated indebtedness, the government has the option to avoid a default, by printing bank notes, having the central bank underwrite government bonds, increasing taxes, etc., whereas such options are not available for foreign currency-denominated bonds. Contrary to the general approach, Moody's assigned an A2 rating to domestic currency-denominated bonds, which is four notches below that of foreign currency-denominated bonds. This implies that Moody's considers, when Japan falls into difficulty in servicing its debt, the government is highly likely to give priority to repaying foreign currency-denominated debts rather than to domestic debts. So far, Moody's has not explained sufficiently the reasoning behind its decision.

(3) Rating agencies attach great importance to fiscal indicators among macro-economic fundamentals, in rating Japan's sovereign issues. However, they do not pay consideration to the fact that Japan still has the capacity to increase taxes and levies, since the country's tax burden is the lowest among the G7 countries, along with the United States.

(4) Rating agencies, with their excess emphasis on fiscal indicators, do not make a sufficiently comprehensive assessment based on macro-economic indicators.

(5) Until recently, ratings on sovereign debts had been considered to serve as a ceiling for ratings of other domestic issuers. However, Moody's introduced the concept of country ceilings several years ago, and ratings of domestic corporations are no

longer linked to the government bond rating (currently the country ceiling for Japan is Aa1). Consequently, many domestic companies are currently rated higher than Japan's domestic currency-denominated sovereign rating (Moody's A2). Although the concept of country ceilings addresses the complex issue of the relationship between ratings of sovereign and other domestic issuers, further study and clarification is required.

The three rating agencies have been rating many corporations over several decades. They constantly rate more than several thousand companies. Although there have been some rating failures like Enron, as referred to later, the rating agencies have established a track record for general corporate ratings, showing a close relationship between their ratings and the default ratio; i.e. the lower the rating, the higher the probability of default.

Contrary to corporate ratings, the history of sovereign ratings is relatively short. It became active only in the late 1980s when sovereign governments, mostly OECD members, started issuing bonds actively in the international capital markets. In the 1990s, debt obligations of emerging market economies were also rated, as they started issuing bonds. In Latin America, the Brady plan was launched to settle the decade-long Latin American debt crisis. In accordance with the plan, a massive amount of restructured bank loans of emerging market economies were securitized and actively traded in the secondary market. As a result, many of the emerging economies in Latin America were also rated. Currently, about 100 sovereign governments have been rated by the rating agencies.

Rating agencies have been striving to improve their methodology to rate sovereign debt in a relatively short period, and they are still searching for a better way to handle their ratings. As opposed to corporate ratings, it is extremely difficult to prove the accuracy of complex sovereign ratings based upon empirical default data.

The issue that has emerged as a result of the recent disputes on JGB ratings is that the rating process is not transparent due to lack of accountability of the rating agencies. Unlike other financial services industries, the rating industry, which is dominated by the three rating agencies, is considered as the least competitive. It is important to look at the problems faced by the rating industry which some describe as an oligopolistic system.

3. U.S. Rating System "NRSRO"

In the United States, the Securities and Exchange Commission (SEC) designates a rating agency as a NRSRO, in accordance with a system called "nationally recognized statistical rating organization" (NRSRO). A "nationally recognized" rating agency means that its rating is credible and thus relied upon by users; i.e. bond issuers, investors and other market participants. Therefore, a NRSRO designation reflects the recognition and trust given by the market. It is not a licensing system, whereby the SEC grants a license to a rating

agency if it meets a set of criterion set forth legally. A qualified rating company needs to accumulate rating experience for many years beforeit is designated a NRSRO, making any new entry extremely difficult. This nationally recognized qualification is what impedes, some say, competition in the rating market and has led to today's oligopolistic system.

The SEC designated three NRSROs in 1975, now known as the three rating agencies, in connection with its decision to use NRSRO ratings for securities held by broker-dealers for the purpose of assessing their net capital [iv]. Since then, the SEC designated four rating agencies as NRSROs, including Duff and Phelps, which were subsequently merged or acquired by the three rating agencies. The system dominated by the three rating agencies thus remains unchanged.

In the United States, many laws and regulations require ratings by NRSROs as a safety-standard for managing government or private funds. For instance, money-market funds now totaling US $2 trillion require a NRSRO rating. Furthermore, rating agencies are not obliged to disclose non-public information of a company they obtain prior to ordinary investors, and their ratings are not subject to SEC supervision. The privileged and protected NRSROs in the United States, in effect, assume the role of a public entity and are thus empowered as quasi-governmental institutions, without being subject to supervisionby the authorities.

On March 20, a Senate hearing on "Rating the Raters: Enron and the Credit Rating Agencies" was held at the Committee on Government Affairs. The purpose of the hearing was to address the problem that the rating agencies had maintained Enron's credit rating at an investing grade (BBB), up to four days before it collapsed on December 2 last year, thus causing considerable damage to its investors. In the testimonies, two major observations were expressed: (i) the need to induce competition within the rating industry and (ii) the subject of accountability of the rating agencies which hold a quasi-governmental power. The Commissioner of the SEC, Isaac Hunt, promised to examine (1) the competitive impact of the SEC's use of the NRSRO designition, and (2) whether additional supervision over NRSROs is needed.

The two issues SEC promised to examine are not new. There are many cases in which rating agencies have been criticized and these issues were discussed. Among them, in connection with the collapse of WPPSS, a nuclear power company in the State of Washington in 1983, or of Orange County of California in 1994, the rating agencies were criticized and confronted with legal action for not giving proper ratings. In both cases, rating agencies were not held legally liable for their ratings, as the ratings were considered to be no more than investment opinions. Thus, no specific steps were taken, such as refining the system. Therefore, it is unlikely that drastic changes will be made within the NRSRO system in the near future, such as permitting a number of new NRSROs, or implementing stronger supervision by the regulatory authorities.

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iv Rule 15c3-1 under the Securities Exchange Act of 1934

4. Rating Agencies operating in the Global Markets

The three NRSROs are operating globally, with due recognition given by investors, bond issuers and other market participants worldwide. According to Moody's, out of total revenue of rating agencies amounting to US$2.1 billion in 2001, mostly from rating fee income, S&P, Moody's and Fitch earned $870 million (41%), $797 million (38%) and $302 million (14%) respectively. The three rating agencies together held an overwhelming share of 94% of total revenue.

Moody's became independent from Dun & Bradstreet in 2000 and is listed on the New York Stock Exchange. S&P merged with McGraw-Hill in 1966, currently forming one department of the company. Fitch, a subsidiary of a French company Fimalac, which is listed on the Paris Exchange, has two head-offices in New York and in London. Fitch specializes in bank rating and structured finance. Its market share is almost half of that of S&P and Moody's, but Fitch has been expanding its shares in Europe, centering on European corporations that actively issue bonds, and in Latin America. The three rating agencies are now operating globally, based on their U.S. NRSRO status.

Japan established a designation system for rating agencies in 1992 and appointed the above three rating agencies, Research and Investment (R&I) and Japan Credit Rating Agency (JCR). The history of the Japanese rating agencies dates back only 20 years, but they now rate sovereign issuers and have started expanding their operations in Asia. However, they are still way behind in terms of market recognition compared with the three rating agencies. They have not yet obtained a NRSRO status.

There are about 20 rating companies operating in the Asian region excluding Japan. Most of them were established within the past 10 years, with some form of assistance from the government or the central bank. They specialize in rating bond issues in local markets and do not engage in sovereign ratings. The Asian crisis of 1997-98 was a serious blow to those newly created rating agencies, as the companies they had given high ratings collapsed one after another. Governments in Asia have been making efforts to develop the rating industry. With the help of the Asian Development Bank, the Association of Credit Rating Agencies in Asia (ACRAA), comprised by 13 rating agencies, was formed in Manila in September 2001.

5. Expanding the Scope of Rating Business

It is generally expected that the rating business will expand in its scope and gain more importance. First, bond issues will certainly increase. The country that has the most matured rating system is no doubt the United States, with its highly advanced capital market. Bond issuance in Europe has been sluggish, due to the prevalent indirect financing system, in which banks played a dominant role in providing necessary funds to industries. However,

with the introduction of the Euro in 1999, direct financing will expand due to integration and the improvements made in the European financial and capital markets. According to BIS statistics, net issues of Euro-denominated international debt securities has almost reached the level of US dollars [v]. It is also expected that bond issues will gradually increase in the Asian and Latin American regions. As a result, the rating industry will gain more importance as an indispensable infrastructure for the capital markets in Europe, Asia and Latin America.

Secondly, it is essential to rate new financial products, such as structured finance including asset-backed securities and credit derivatives that are expected to increase further.

Thirdly, according to the proposed Basel II, which is to become effective in 2006, large financial institutions, particularly those operating internationally, are to use their internal risk rating system to calculate capital requirement. However, many financial institutions, under the standardized approach, are to rely on rating by external entities, including rating agencies to assess credit risk. Thus, rating agencies that do not presently play a role under Basel Ⅰ, will perform a quasi-governmental function globally under Basel II.

In view of the growing importance of rating industries in the global arena, what will the rating industry look like in the future? Will it be a system in which the three big rating agencies continue to dominate, or will it evolve into a more competitive one? The most desirable scenario is one where geographically diversified rating agencies provide quality ratings in a more transparent manner, in a more competitive environment.

6. Conclusion; Developing a More Transparent Rating Market

The rating system has been institutionally supporting the credit system, which is an integral part of the financial services industry. The U.S. financial services industries, such as banking, insurance and investment banking, have promoted financial integration globally and have exerted a great amount of influence on the global financial system. The rating industry under the NRSRO system constitutes an important part of the global financial system.

Nevertheless, the NRSRO system developed into the least competitive, due mainly to its designation system based on the "market recognition requirement." This is a difficult concept to quantify when designating a new rating agency as a NRSRO. It has been reported that, although many new applications were submitted to the SEC, they have not been processed for a long time [vi].

Whether the rating industry will become more competitive and transparent will depend upon two factors. First, whether the U.S. SEC designates more NRSROs, including non-U.S. rating agencies, and second, in view of the expanding rating business, whether non-U.S. rating agencies can compete with the three rating agencies. The question is whether other non-U.S. rating agencies, in particular, rating agencies in Japan, with a huge capital market,

v Bank for International Settlement Quarterly Review, June 2002
vi New York Times article by Leslie Wayne carried by Herald Tribune of April 24, 2002, Financial Times article of May 21, 2002

can strengthen their presence in the market and compete with the three rating agencies.

Rating is an expression of an opinion held by private sector rating agencies concerning the creditworthiness of issuers of securities and other financial obligations. Ideally, such an opinion should be provided to market participants as a market-based financial service that is free from any regulatory supervision. The importance of an environment in which rating companies can freely express their opinion is unquestionable. However, the premises for the freedom of expression entail a more competitive environment as well as greater transparency.

When rating lacks transparency due to insufficient disclosure of information, including the basis for rating, the credibility of the rating itself is questioned. Although it is not easy to clearly pin-point the reasons for the present lack in disclosure of information, it can be surmised that one of the causes is the oligopolistic environment in which rating agencies operate. If the market remains non-competitive and its detriment can no longer be overlooked, regulation could be strengthened vis-a-vis the rating agencies that are gaining importance as quasi-governmental agencies. In order to avert such a situation, it is desirable that the rating agencies themselves endeavor to enhance transparency.

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Address: 3-2, Nihombashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan

Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町1-3-2

電話：03-3245-6934(代)ファックス：03-3231-5422
e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp/