CREDIT RATING AGENCIES AND THEIR INFLUENCE ON CRISIS

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Abstract: *Credit ratings have a significant impact on the functioning of markets and the confidence of investors and consumers, investors using them to assess credit risk. Having a major role in the proper functioning of financial markets, it is vital for these rating agencies to operate in a manner more objective and credible as possible. In the world there are several rating agencies, but in reality counts only 3 (The Big Three): Moody's, Standard & Poor's and Fitch, who account for almost 95% of the market. Rating agencies have been the subject of intense criticism because of the role they have had in the trigger of financial crisis. Given that the major rating agencies are American, the U.S. having a particular interest in the euro area can raise the question whether this wave of downgrades is not a part of the scenario under which the U.S. has managed to export its own crisis around the world.*

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1.Introduction

Credit rating agencies play an important role in global banking and securities markets, because their credit ratings are used by investors, borrowers, issuers and governments in making investment and financing decisions. According to the Regulation no. 1060/2009 of the European Parliament and of the Council of 16.09.2009 on credit rating agencies, the term " credit rating " is defined as " an opinion, granted on a well established and defined classification system of rating categories on the creditworthiness of an entity a debt or financial obligation, a debt security or preferred stock or other financial instrument or an issuer of such debt or financial obligation, debt or preference shares and other financial instruments". Rating is actually an assessment of the financial health of an entity. Any entity may have a rating, from a company to a country. On the other hand, the term "credit rating agency" means a "legal person whose business includes providing professional basis of credit ratings" (Official Journal of the European Union L 302/1 of 17.11.2009 - Regulation 1060 /2009 on credit rating agencies).

A credit rating refers only to credit risk, other risks such as market risk and liquidity risk are not considered.

Credit ratings have a significant impact on the functioning of markets and the confidence of investors and consumers. Therefore, it is essential that credit rating activities to be carried out with the principles of integrity, transparency, accountability and good governance to ensure that credit ratings are independent, objective and of adequate quality.

2. Rating agencies and credit ratings issued

In the world there are several rating agencies, but in reality counts only 3 (The Big Three): Moody's, Standard & Poor's and Fitch, who account for almost 95% of the market. Credit ratings given are expressed on a scale of letters and numbers.

Figure 1. Rating description: http://en.wikipedia.org/wiki/Credit_rating, accessed on April 2014.

Moody's		S&P		Fitch		rating description
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3		BBB-		BBB-		
Ba1	Not prime	BB+	B	BB+	B	Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely speculative
Caa3		CCC-				Default imminent with little prospect for recovery
Ca		CC				
		C				
C		D	/	DDD	/	In default
/				DD		
/				D		

Ratings have particular importance in financial markets, investors using them to assess credit risk. Ratings affect the interest rate that the borrower must pay the lender. A reduction in rating will result in a higher interest rate.

For a country, credit rating reflects the risk of its business environment and is used by those who want to invest abroad. It takes into account political risk. A low rating indicates the opinion of agency that the company or country has a high risk of bankruptcy, the rating based on analysis of the entity's history and long-term economic forecast.

Credit rating agencies play an important role in financial supervision institutions. In the EU, to cover certain risks, financial institutions are required to hold a minimum level of financial resources. This capital will be used for the emergence of unexpected losses, also protect depositors and contribute to financial system stability. The key role of agencies is emphasized by the fact that banks often require that certain assets have a

certain level of rating to be accepted as collateral, if certain financial institutions will require a loan to the central bank. For example, until recently the European Central Bank demanded that certain assets to have a credit rating of at least BBB- (Jackob de Haan, Fabian Amtenbrink, 2011).
Having a major role in the proper functioning of financial markets, it is vital for these rating agencies to operate in a more objective and credible as possible.
In the early twentieth century, the ratings were based on subscriptions and were purchased by investors. Now the agencies are paid by issuers of financial instruments for the rating. Amounts paid by issuers for providing these ratings represent almost two thirds of the total income of a credit rating agency. However, there are some ratings that are provided free of charge, but they are not as accurate because it is based only on certain dates / public information.
But this system in which financial product issuer pays the rating agencies is very dangerous. On the one hand, agencies are tempted to overestimate the credibility of issuers of financial products, considering that the main source of income represents amounts paid by issuers and thus want to maintain a good relationship. On the other hand, agencies must retain credibility in the market, otherwise their ratings would have no market value. Concrete example is the case of the U.S. in the previous period of the subprime mortgage crisis in 2007, when credit agencies have rated to high for risky mortgages, just because they put first incentives received and not their reputation in the market.

3. Sovereign credit rating

Credit ratings of credit rating agencies to countries is an assessment of the government regarding its ability and willingness to pay its debts and interest on time. In perspective, these ratings measure the probability of default of credit by the government of a country. A credit default refers to the inability to pay on time the debt of countries and the interest. Figure below shows the countries credit ratings issued by major rating agencies 3.

Figure 2. Long term sovereign debt ratings

COUNTRY	S&P Rating		Moody's rating		Fitch Rating	
ALBANIA	B	STABLE	B1	STABLE		
ARGENTINA	CCC+	NEGATIVE	Caa1	Stable	CC	
AUSTRALIA	AAA	STABLE	Aaa	STABLE	AAA	STABLE
AUSTRIA	AA+	STABLE	Aaa	STABLE	AAA	STABLE
BELARUS	B-	STABLE	B3	NEGATIVE		
BELGIUM	AA	STABLE	Aa3	STABLE	AA	STABLE
BOSNIA AND HERZEGOVINA	B	STABLE	B3	STABLE		
BRAZIL	BBB-	STABLE	Baa2	STABLE	BBB	STABLE
BULGARIA	BBB	NEGATIVE	Baa2	STABLE	BBB-	STABLE
CANADA	AAA	STABLE	Aaa	STABLE	AAA	STABLE

CHILE	AA-	STABLE	Aa3	STABLE	A+	STABLE
CHINA	AA-	STABLE	Aa3	STABLE	A+	STABLE
COLOMBIA	BBB	Stable	Baa3	POSITIVE	BBB	STABLE
CROATIA	BB	Stable	Ba1	NEGATIVE	BB+	Negative
CUBA			Caa1	STABLE		
CYPRUS	B-	Stable	Caa3	POSITIVE	B-	NEGATIVE
CZECH REPUBLIC	AA-	STABLE	A1	STABLE	A+	STABLE
DENMARK	AAA	STABLE	Aaa	STABLE	AAA	STABLE
EGYPT	B-	STABLE	Caa1	NEGATIVE	B-	sTABLE
ESTONIA	AA-	STABLE	A1	STABLE	A+	STABLE
FINLAND	AAA	NEGATIVE	Aaa	STABLE	AAA	STABLE
FRANCE	AA	STABLE	Aa1	NEGATIVE	AA+	STABLE
GERMANY	AAA	STABLE	Aaa	STABLE	AAA	STABLE
GREECE	B-	STABLE	Caa3	STABLE	B-	STABLE
HONG KONG	AAA	STABLE	Aa1	STABLE	AA+	STABLE
HUNGARY	BB	STABLE	Ba1	NEGATIVE	BB+	STABLE
ICELAND	BBB-	STABLE	Baa3	STABLE	BBB	STABLE
INDIA	BBB-	NEGATIVE	Baa3	STABLE	BBB-	STABLE
IRELAND	BBB+	POSITIVE	Baa3	Positive	BBB+	STABLE
ISRAEL	A+	STABLE	A1	STABLE	A	Positive
ITALY	BBB	Negative	Baa2	Stable	BBB+	Negative
JAPAN	AA-	NEGATIVE	Aa3	STABLE	A+	NEGATIVE
LIECHTENSTEIN	AAA	STABLE				
LITHUANIA	A-	STABLE	Baa1	STABLE	BBB+	POSITIVE
LUXEMBOURG	AAA	STABLE	Aaa	STABLE	AAA	STABLE
MEXICO	BBB+	STABLE	A3	STABLE	BBB+	STABLE
MOLDOVA			B3	STABLE		
MONTENEGRO	BB-	NEGATIVE	Ba3	STABLE		
NETHERLANDS	AA+	STABLE	Aaa	STABLE	AAA	NEGATIVE
NEW ZEALAND	AA	STABLE	Aaa	STABLE	AA	STABLE

NORWAY	AAA	STABLE	Aaa	STABLE	AAA	STABLE
POLAND	A-	STABLE	A2	STABLE	A-	Stable
PORTUGAL	BB	Negative	Ba3	STABLE	BB+	POSITIVE
PUERTO RICO	BB+	Negative	Ba2	Negative		
QATAR	AA	STABLE	Aa2	STABLE		
REPUBLIC OF THE CONGO	B+	STABLE	Ba3	STABLE	B+	STABLE
ROMANIA	BB+	POSITIVE	Baa3	NEGATIVE	BBB-	STABLE
RUSSIA	BBB	NEGATIVE	Baa1	RUR-	BBB	NEGATIVE
SERBIA	BB-	NEGATIVE	B1	STABLE	B+	STABLE
SLOVAKIA	A	STABLE	A2	STABLE	A+	STABLE
SLOVENIA	A-	STABLE	Ba1	Stable	BBB+	NEGATIVE
SPAIN	BBB-	STABLE	Baa2	Positive	BBB	Stable
SWEDEN	AAA	STABLE	Aaa	STABLE	AAA	STABLE
SWITZERLAND	AAA	STABLE	Aaa	STABLE	AAA	STABLE
TURKEY	BB+	Negative	Baa3	NEGATIVE	BBB-	STABLE
UKRAINE	CCC	NEGATIVE	Caa3	Negative	CCC	
UNITED ARAB EMIRATES	AA	STABLE	Aa2	STABLE	AA	STABLE
UNITED KINGDOM	AAA	NEGATIVE	AA1	STABLE	AA+	STABLE
UNITED STATES	AA+	STABLE	Aaa	STABLE	AAA	STABLE
URUGUAY	BBB-	STABLE	Baa3	POSITIVE	BBB-	STABLE
VENEZUELA	B-	NEGATIVE	Caa1	NEGATIVE	B	NEGATIVE
VIETNAM	BB-	STABLE	B2	STABLE	B+	Positive

Source: http://www.tradingeconomics.com/romania/rating, accessed on April 2014.

Rating agencies have a complex set of qualitative factors which analyzes such as institutional strength, political, fiscal and monetary stability, economic and environmental vitality, also the history of a country in terms of total debts. These qualitative factors are added some quantitative factors such as the level of debt, international reserves, the composition of debt and the cost of credit, also (Jackob de Haan; Fabian Amtenbrink, 2011).

Credit rating of a country influence the development of the financial market, directly affecting the price of bonds. Effect of credit rating is felt well on the stock market.

Moreover, the reduction in the credit rating of a country's financial market influences other countries, too.

4. Rating agencies and crises

Rating agencies have been the subject of intense criticism, because of the role they have had in the financial crisis. They were given the highest rating for 11 significant financial institutions, that later either failed, either had serious problems.

Financial giant "AIG" received the "AA" rating, even though he had serious problems. Investment bank Lehman Brothers maintained its rating on the investment until a few days before the collapse.

Untill the beginning of the subprime crisis in 2007, the three ratings agencies have maintained "AAA" to thousands of instruments, which soon proved to be very risky.

Moody's, for example, was a factory for ratings "AAA". From 2000 to 2007, awarded this rating for 42 625 securities based on subprime mortgages. In 2006 the value of these securities with maximum rating was of 869 billion dollars, 83% of which will be lower six months later. (Emily McClintock Ekins and Mark A. Calabria, 2012).

Senate Permanent Subcommittee dealing with research into the causes of the crisis had several hearings. Those who were interviewed were the heads of Moody's and S & P, which contributed greatly to the deepening crisis. Some of the conclusions of U.S. Senators are:

(http://economie.hotnews.ro/stiri-finante_banci-11211417-agentile-rating-jocurile-culise-care-distrug-sau-coafeaza-economie-vezi-cat-castiga-cum-iau-deciziile-comitetele-rating.htm):

1) The rating models used were inaccurate. Between 2004 and 2007, Moody's and Standard & Poor's used "inappropriate" numbers to estimate how big the risk in residential mortgages was.

2) Competitive pressure made the employees of rating agencies to rate false the performance of their clients.

3) Although we knew that the ratings provided could mislead investors, rating agencies continued to operate with incorrect numbers and models.

4) Despite strong gains, rating agencies have not invested in resources to improve the scoring.

5) When they lowered the massive ratings of thousands of companies in July 2007 and then in January 2008, they caused a financial market shock, causing substantial losses and contributing to the deepening crisis. Sometimes ratings were lowered from AAA to junk directly. In other cases, though employees do not recommend good ratings, the management of the rating agencies rated certain products with the best rate (AAA), because they wanted to keep their client.

Regarding the debt crisis, for a decade rating agencies have systematically ignored the structural problems of the economies. Only in 2009, after the Greek government admitted that he lied about its public deficit, it began the cycle of the degradation .

At the time, Greece was rated with A, the fifth scoring out of 20. In May 2009, Standard and Poor's downgraded Greece's bond hedge, this action was followed shortly by the Fitch and Moody's agencies. The same thing happened in Ireland and Portugal, although their debt still stood above the speculative (http://www.romanialibera.ro/exclusiv-rl/documentar/esecuri-rasunatoare-ale-agentiilor-de-rating-269207.html#top_articol).

The decline of the agency's rating has an immediate effect. When a debt is not denoted with a safe investment rating (A), banks, pension funds and insurance must sell, fueling the fall of their interest and thus increasing the financial markets. So follows another degradation of the rating agencies and therefore new sales. A chain maintained by these agencies, by monopolizing European economic environment.

On 5 August 2011, S & P downgraded U.S. debt for the first time in history. "AAA" rating, the best possible, was reduced by one notch to "AA+ (http://www.zf.ro/business-international/incepe-decaderea-daca-sua-ar-fi-fost-in-europa-acum-ar-fi-mers-dupa-bani-la-ue-si-fmi-8173129).
On 13 January 2012, after a prior warning, S & P downgraded the rating of 10 eurozone countries, attracting numerous critics.
(http://placeduluxembourg.files.wordpress.com/2012/01/sp-rating-action-13_01_2012.png?w=419&h=423).

5. Controversies and penalties

Given that the major rating agencies are American, the U.S.A. having a particular interest in the euro area, can raise the question whether this wave of downgrades is not a part of the scenario under which the U.S. has managed to export its crisis around the world. Is possible that U.S.A. to use any means to maintain its current dominance and to restore the European market at the level of a simple market place.
The disappearance of the eurozone and of the single currency could be beneficial for those who hunt for some time the European market. Dividing this market into initially markets allows easy control and new rules dictated by global business leaders who can be in such a situation, the real winners of the European crisis. The disappearance of the eurozone and the single currency would mean dividing the European market, and this would allow business leaders to establish new global rules and easy control; the real winners in this scenario of the current European crisis would be U.S.A. (financiarul.ro, 2012).
Since the financial crisis in 2008 and the emergence of economic problems in the PIIGS (Portugal, Ireland, Italy, Greece, Spain), criticism of European governments to the rating agencies have been increasingly vocal.
After the mass ratings downgrade of European countries, many European leaders have criticized the rating agencies, giving them the credibility and good faith and once again bringing into question the necessity of establishing a European rating agency.
Rating agency Standard & Poor's (S & P) has been found guilty of the Federal Court of Australia for having misled investors paying the highest rating, "AAA" of financial derivatives that were devalued during the financial crisis. It is the first time that such an agency is sued and convicted for the evaluation of financial derivatives. Following the decision of the court of Australia, councils will receive compensation of 16 million Australian dollars, but the total cost charged to the accused parties could rise to 30 million Australian dollars, including costs and interest. (Michael Hedtstueck, 2012).
Credit rating agencies contributed to outbreak and deepening global financial crisis, giving numerous inaccurate ratings.

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