Role of rating agencies

Business

Attention is rarely directed towards a rating agency after publishing rating results instead all focus shifts towards the agency in question. This snatches denies an opportunity to interrogate the manner of doing, the benefits of doing so and to whom and more so the need of the rating agency.

The case was not different when rating agency Standard and Poor’s sliced the previous rating of France sovereign credit rating from AAA to AA. In their statement, the company cited lack of strong political and policy making European institutions to which France is an integral part. The merits of this decision may not be the entire subject of this paper; rather the discussion that follows will seek to answer the question of real and perceived role of the rating agencies. Further, this paper will investigate the necessity of rating agencies, whether their role is constructive and their assessment dependable and ultimately the failures and policy issues surrounding their existence (StandardandPoor’s 2012, pp. 6).

Role of credit rating agencies Credit rating institutions gather, group, analyze financial information on a given institution, and use it to gauge the potential risk and returns associated with it; this is their central or real role. However, in recent times these ratings have become an essential part of the business community mostly aiding investors tin planning their investments. Rating has also gained grounds as a part of regulation and a high rating is essential in a number of business quarters. Given their ability to bring down or boast a business, they have curved their own niche in the market creating perceived roles beyond oversight. Such has misled investors by attaching lots of weight on their results without examining the faults in them (Herring 2009, pp.

9-11). Current situation pertaining to rating agencies Situations and circumstances upon which credit rating agencies operae have changed over the years. Historically, these agencies dealt with the corporate financial market alone and assessed securities by comparing expected cash flows versus the risk of default leading to loss. However, today the agencies have plunged into the structured market characterized by complex and extensive use of derivatives. The question is whether their ratings on this institution would be sound on a risk basis considering the unlimited diversification of risks this market offers. Notable, is the fact that structured markets such as CDOs hedge on credit sensitive underlying securities.

The ability of these agencies to develop a model that would calculate the risk of all underlying assets individually and combined remains in question (Coval et al, 2008). While the mentioned situation of a more complex market makes rating more difficult, it also creates a need for rating agencies to be more vigilant in a view to ensuring a proper rating. A solution to this paradox is the development of better models and transparency. Policy makers argue that rating agencies need to publish all assumptions used in their computation and state clearly their opinions. This will aid in eliminating the deception that ratings are official positions. Notable is the political reaction to ratings given the importance it has received.

The approach should be cautious, and individual entity analysis should be the grounds of decision-making and not ratings. Do rating agencies evaluate economic growth perspectives, or consider the standpoint of debtors alone? In answering the question of credit ratings institutions ability to evaluate economic growth perspective, my opinion is that they have not. As explained

above, their entering into structured markets has presented new challenged demanding new capabilities. The information from ratings majorly is on cash flow risks and default probabilities that cannot sufficiently aid in many decisions such as pricing. Given the complexity of structured markets mentioned above, the rating results leave informational gaps especially by failing to capture how payoffs co-vary with prevailing economic states. In 2007-2007, rating agencies used the same metrics to rate structured products; the results were an inaccurate projection just before the collapse of the US subprime mortgage market.

Concerns of rating agencies considering debtors alone are legitimate and arise out of a conflict of interests, especially in the question of who is paying the rating agencies. The proposal is to have a go between official institutions that collect fees from businesses upfront before ratings; this will encourage transparency and reduce collusion (Coval et al 2008, pp. 20-23). Are rating agencies constructive? However, despite these shortfalls, the overall functions of ratings agencies are constructive and importance. In their absence, a lot of information disparity would exist between issuers and investors. They aid the investors in achieving information symmetry and with scrupulous regulation, their role, as a check is undeniably vital.

A gatekeeper, which is the suitable description to their role, is a respectable role requiring adequate regulation (Herring 2009, pp. 16). Should politicians base their decisions on CRAs assessment? In analyzing, the wisdom behind using ratings to make decisions by politicians' attention towards credibility and scope is necessary. In many instances, decisions have two sides to them and the most informed side are likely to make the best decision. Several

voices state that there exist conflicts of interests in rating products and entities. Lack of appropriate models to assess' products is also a concern.

Given the above information, it is wiser for politicians to make note of ratings made, asses their bases, acknowledged the facts in them but use them as an extension to their own analysis, not as an end in themselves (Shapiro 2009, pp. 15).