Big 3 Ratings Firms Facing Competition

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The first rumblings of serious international competition to the Big Three credit ratings firms were heard last week when ratings organizations from five separate countries said they will merge into a single ratings entity to offer a global alternative to debt issuers.

ARC Ratings said it will combine the operations of CPR of Portugal, CARE Rating of India, GCR of South Africa, MARC of Malaysia and SR Rating of Brasil. The unified firm will be headquartered in London and is expected to open for business by early 2014.

The Big Three firms – Standard & Poor's, Moody’s and Fitch – have come under fire in recent years both in the U.S. and abroad.

In the U.S., all three have been cited as significant contributors to the financial crisis of 2008 for apparently rubber-stamping favorable ratings on all manner of bonds in an effort to increase profits. Critics of the firms’ for-profit business model have pointed to an inherent conflict of interest – the issuers pay the firms to grade their debt.

In the run up to the financial crisis it wasn’t uncommon for issuers -- primarily the large investment banks -- to switch ratings firms until they got the favorable grades they sought.

During the recent debt crisis in Europe the Big Three were again targeted for criticism by government and banking officials angry that the firms had downgraded the credit of countries such as Spain, Italy and Portugal. These officials argued that the downgrades just exacerbated an already difficult situation and contributed nothing to a solution.

Spokesmen for Standard & Poor's, Moody’s and Fitch didn’t respond to requests for comment on the potential for additional competition.

Need to Establish a Track Record

Industry experts generally applaud the idea of additional competition, noting that the Big Three have dominated the ratings market for years and currently gobble up about 90% of the market.

“I think this is a great thing. We need more competition in this space,” said Mark Calabria, director of financial regulation studies at the Cato Institute.

But Calabria said ARC Ratings will have to establish a track record of independence, proof that the unified firm can act independently of the governments from the five countries where the separate firms originally did business.

“There will be a market test,” said Calabria. “It will be a while before ARC is used as a standalone for issuers.”

Lawrence Wright, a financial regulation expert and economist at New York University, agreed that it will be years before a new ratings firm can legitimately compete with the established three.

“There’s a whole nest of issues. You can’t just waltz in and say you’re a ratings firm. It’s not that easy,” said Wright.

The test for credibility, according to Wright, will be in how well the new firm’s ratings hold up over time. In other words, can the firm’s ratings be trusted.

The credibility of the Big Three was broadly questioned after billions of dollars in debt -- much of it in the form of mortgage-backed securities -- had to be downgraded from the AAA rating issued by the firms ahead of the financial crisis. When the U.S. housing bubble burst around 2007 and millions of homeowners began defaulting on their mortgages, much of the debt earlier graded as AAA was determined to be far less creditworthy.

In a statement announcing its formation, ARC Ratings noted the failures of the Big Three ahead of the financial crisis and suggested the ratings industry as it currently exists is U.S. centric. “Working together, (ARC Ratings) will provide ratings answers to the new multi-polar world economy in direct competition with US-centric agencies,” the new firm said.

Wright said regardless of ARC’s motives, its apparent dislike of a U.S.-dominated industry, a new competitor in the credit ratings sector could forge new technologies and potentially new business models.

“As a general matter, I like more competition,” said Wright.

“The Question is Quality”

A counter view, however, holds that more competition among ratings firms will only put additional pressure on the existing firms to accommodate the issuers in order not to lose market share.

“I don’t think having one more CRA (credit rating agency) is going to solve the problem. In fact, I think it will make it worse. More CRAs increases the likelihood that the firms will increase ratings to increase their market share” said Rosa Abrantes-Metz, a director at research firm Global Economics Group. “Price competition isn’t the problem. The question is quality.”

Abrantes-Metz said credibility in the ratings industry could be restored and heightened if securities regulators established a structure in which new debt was distributed to the ratings firms on an equal basis. Under that system, the first firm to rate a debt product would be under no financial incentive to rubber stamp a top rating, she explained.

The issuer could always seek another rating for its bonds, but the first rating would stand as an objective rating untainted by conflicts of interest, said Abrantes-Metz.

“There has to be an incentive to provide honest ratings,” she said.