

# Rating Agencies: Don't shoot the messenger!

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Will the accused please stand!

In the vast auditorium of modern-day capitalism, there is no end to the search for the culprits of the crisis in confidence currently hitting financial markets. After the corrupt manager, the blind or powerless statutory auditor, the manipulative financial analyst and the immoral investment bank, it is now the turn of the rating agencies to face public disgrace. They have to reply to a serious accusation: that of increasing the volatility of the markets due to their irresponsible behavior.

However, the accused should appear more as a minor figure. Agencies' ratings are issued for the attention of bondholders and not shareholders. Their analyses, which the rating agencies themselves recognize as subjective, relate only to the solvency of issuers and leave many other aspects of companies to the shrewd judgment of observers and investors.

After taking a closer look, the inconsistencies of the accusation are also particularly striking: rating agencies are criticized for having acted either too late or in great haste. They are accused of complacency, due to the conflicts of interest created by the way in which they are paid, or of taking a hard line with companies clearly in the process of financial turnaround. They are suspected of lacking rigor. Their dominating position is alleged to be the result of protective regulations, although it is recognized that historically, they have managed to keep their reputation intact.

Yet one thing is certain: to a great extent, rating agencies escape any control or regulation. This is not healthy given the impact of their decisions on markets and issuers. This is largely the reason for the discussions currently being held by US or European regulators on ratings.

Rating agencies have always played a vital role for all investors. Yet the recent flaws in financial markets have given them considerable *de facto* power. Reducing their influence to a more balanced level will involve improving the conditions in which information is provided to investors, rather than changing their status.

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Rating agencies play a vital role for all financial market players. Their primary role is, of course, to serve the bond market.<sup>1</sup> But in actual fact, all market players are interested, and shareholders especially, since the rating is a key indicator of the creation and distribution of enterprise value.

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<sup>1</sup> The issue of sovereign ratings will not be dealt with here.

*Serving the needs of bondholders...*

A rating is a relative opinion as to the overall capacity and willingness of an issuer to meet its financial obligations. It is thus primarily intended for bond market participants: issuers, investors, financial intermediaries, and banks.

Issuers are keen to provide an independent opinion on their credit risk to investors. This allows them to improve the liquidity of their listed financial instruments and to reduce their spread.<sup>2</sup> The interest of the rating from a financial standpoint is genuine despite the costs involved.<sup>3</sup> Companies generally use the two main rating agencies (Standard & Poor's and Moody's), but many also ask a third agency for an opinion. It would appear that companies rated by a third rating agency improve their cost of funding.<sup>4</sup>

Bond investors are naturally interested in the probability of default that can be computed using the rating. In this regard, historically, there appears to be a high degree of correlation between the rating assigned at the beginning of the issue and the probability of default<sup>5</sup> during its lifetime: thus, after a period of 15 years, 0.5% of S&P's AAA-rated issuers defaulted, as compared to 35.8% of B-rated issuers.<sup>6</sup>

Financial intermediaries such as investors, analysts or sellers also frequently use ratings, either for their own analytical purposes, as an additional item of information for their clients, or even for technical reasons (rules governing investment funds in the US prohibit them from investing in speculative instruments, i.e. those rated below BBB).

Finally, these ratings are used by banks, and more generally, companies' creditors, in loan agreements. This has led to a proliferation of clauses providing for "ratings triggers" in recent years. These clauses allow creditors to require the repayment of their debt or to have the interest rate increased should a rating fall below a specific threshold provided for in the loan agreement.<sup>7</sup> Despite the potential risks these clauses represent for the companies concerned, they are not necessarily made public.

*...but also of shareholders!*

Alongside these traditional beneficiaries, there is another player who long went unnoticed: the shareholder. In fact, a large number of studies have been made of the impact of ratings on the value of stock.<sup>8</sup> It is a well-known fact that rating downgrades (or upgrades) are

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<sup>2</sup> The spread is the difference between the interest earned on a loan and the interest that would be earned on a Government bond with the same maturity.

<sup>3</sup> In general, it is companies who pay rating agencies.

<sup>4</sup> "The Impact of the Third Credit Rating On the Pricing of Bonds", Jeff Jewell and Miles Livingston, Journal of Fixed Income, December 2000, cited by Fitch during the hearings organized by the SEC in November 2002. See <http://www.sec.gov/news/extra/credrate/fitchratings1.htm>.

<sup>5</sup> Default is the failure to meet a financial obligation. However, it does not mean that the company has gone bankrupt.

<sup>6</sup> Ratings Performance 2001, Standard & Poor's, February 2002.

<sup>7</sup> "Moody's analysis of US corporate ratings triggers heightens the need for increased disclosure" Moody's, July 2002.

<sup>8</sup> "Bond Rating Agencies and Stock Analysts: Who Knows What and When?", Ederington, Louis, and J.C. Goh, 1998, Journal of Financial and Quantitative Analysis 33, 569-585

usually made after a period of abnormal negative (positive) returns on stock. Clearly, these downgrades are, to a certain extent, a response to information already embodied in share prices and in the forecasts made by analysts. However, the fact that the market again reacts negatively and very rapidly indicates that changes in ratings add information previously unknown to investors. Conversely, an upgrade in the rating has no impact on the market (this situation is consistent with companies' preference to disclose good news, rather than bad).

The use of the options theory<sup>9</sup> provides for a better understanding of the reason why ratings provide shareholders with important information on value creation and distribution within companies.

This theory is based on the observation that there is a fundamental asymmetry between shareholders and creditors: the liability of shareholders is limited to the funds they invest in a company, but there is no limit to their potential gain. Conversely, creditors can only hope to recover the amount of their funds, at best.

It is as though the indebted company's shareholders held a call option on the company's economic assets: upon maturity of the debt, if the value of the assets exceeds the amount of said debt, the creditors are repaid (the value of the debt is the exercise price for the call option), and the shareholders recover the residual value of the economic assets. For shareholders, the market value of equity is equal to the value of the call option held on the economic assets.

Should the value of the assets be lower than the amount to be repaid, the shareholders may exercise the put option implicitly granted by the creditors: the shareholders leave them what remains of the assets. The value of the debt for the creditors thus consists of the present value of the debt to be repaid (discounted with a risk-free rate), less the value of the put option on the economic assets granted to the shareholders by the creditors.<sup>10</sup>

This option-based perspective of financial structure is particularly enlightening when the value of the assets is less than the value of the debt, or is roughly equivalent to said value. In all cases, it is a useful tool for understanding the relationship between the analysis of a company's solvency and its shareholder value.

In fact, the analysis of credit risk is about several parameters that are determining factors in calculating the value of these options:<sup>11</sup>

- The risk of loss in value of the economic assets (the underlying assets) owing to an unsuitable strategy or poor execution.
- The increase in the volatility of future cash flows (hence, the volatility of the underlying assets) that would derive from a riskier strategy allowing the above-

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<sup>9</sup> For a presentation of the application of this approach to issues concerning financial structure, see: Principles of Corporate Finance, R. Brealey and S. Myers, McGraw Hill.

<sup>10</sup> For shareholders, the value of equity is equal to the value of the economic assets less the present value of the debt discounted using a risk-free rate, plus the value of the put option on the economic assets.

<sup>11</sup> The value of an option is determined by the value of the underlying asset, its volatility, the duration of the option, the exercise price, the dividend and the risk-free interest rate.

mentioned asymmetry between the situation of shareholders and that of creditors to be taken advantage of.

- The rescheduling of the debt (life of the option) that gives shareholders more time to consolidate their position.
- The increase in the debt (exercise price) that weakens companies by increasing their financial obligations with regard to third parties.
- The increase in dividends that enables shareholders to reduce their investment (and, in general, all financial decisions leading to a reduction in the guarantees offered to creditors).

It is interesting to note that, contrary to financial options, these parameters can be largely influenced by management when it creates and prepare decisions regarding the distribution of the company's value among its beneficiaries (shareholders, creditors and management by means of stock options).

The table below traces the impact caused by the materialization of these risks on the value of the call and put options held by the shareholders.

Credit risk parameters	Call	Put
Loss in value of operating assets	↓ ↘	↗
Increase in the volatility of assets	↗	↗
Rescheduling of debt	↗	↗
Increase in debt	↘	↗
Increase in dividends	↘	↗

This approach allows for a better understanding of why the position of rating agencies is important for shareholders. Although ratings are only intended for bondholders, all analyses underlying such ratings are based on parameters that are vital for determining the company's market value. Therefore, it is only natural that shareholders look to opinions issued by rating agencies and try to decipher the reasons behind a change in outlook or in the rating assigned.<sup>12</sup>

#### *A holistic approach to the company*

The methodology of the rating process<sup>13</sup> is a multi-faceted approach comparable to that developed in a company valuation, with an additional dimension covering the analysis of the distribution of value among finance providers.

<sup>12</sup> As the rating is relative, it can even contain information on the solvency of a rated company's peers.

<sup>13</sup> "Corporate Ratings Criteria", Standard and Poor's, 2002, or "La notation Moody's: *Mode d'emploi* (French Rating Brochure), 1997.

Far from being a mechanical task using default models, the approach primarily consists of measuring the current and future volatility of economic assets and of ensuring that the financial structure is compatible with the company's business dynamics.

The first phase therefore involves focusing on the operational risk as it is difficult to withstand a high financial risk if the level of operational risk is also high. The components of operational risk include the characteristics of the sector, the company's competitive situation and management quality. Management quality is crucial to this analysis. On the basis of contacts with the company's corporate officers and senior management, analysts assess the credibility of the management team and its risk appetite. The study of the organization, the quality of accounting data and the principles of its financial policy allow analysts to determine the company's ability to execute its strategy and management's financial sophistication.

The analysis of financial risk consists of studying the profitability of the company and its ability to meet its financial obligations in the future. The two key components of the analysis are the return on capital employed and the company's ability to generate the cash flows required to fund growth as well as meet its financial obligations as they fall due. The remaining components of the financial analysis involve an analysis of financial leverage, the characteristics of the debt, the value of the existing assets and any off-balance sheet commitments.

The system of corporate governance also forms an integral part of the rating methodology.<sup>14</sup> It does not merely involve verifying the composition of the Board of Directors or understanding its role. This simplistic view would not really address the core issue: how are agency conflicts resolved (or limited)? The analysis thus looks to management's behavior with respect to its shareholders and their backers.

Rating agencies are interested in situations which could lead either to a destruction of value or a transfer of value. In the first case, this would be the result of strategic errors caused by action or failure to act. The second case involves decisions which transfer value:

- To shareholders (therefore to the detriment of creditors): e.g. investments that increase the company's risk profile but do not increase its value;
- Or to corporate officers or one class of shareholders (to the detriment of other classes, often minority shareholders). These "private benefits" are either pecuniary benefits (such as transfer prices, preferential agreements, or remuneration not applied at arm's length rates) or non-pecuniary benefits (access to privileged information, specific political, social or other type of influence).

From the standpoint of creditors, these situations are examples of behavior that is either immediately harmful (by reducing the guarantees in the event of default) or potentially harmful. Even if those private benefits do not affect them directly, they serve as an indicator of management ethics and of the level of control exercised by the Board of Directors over the management team. If the interests of minority shareholders are disregarded, then it is possible that creditors' interests may also eventually receive the same treatment.

Standard & Poor's lists several irregular corporate governance situations that impaired creditworthiness:

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<sup>14</sup> "The evolving role of Corporate Governance in credit rating analysis ", S&P, October 10, 2002

- A dominant group of shareholders that applied company resources to personal or unrelated use;
- Uncontrolled executive compensation programs;
- Management incentives that compromised long-term stability for short-term gain;
- Inadequate oversight of the integrity of financial disclosure, which resulted in heightened funding and liquidity risk.

These situations are far from exceptional within companies, and management as well as members of the Board of Directors need to realize that corporate governance has a significant impact on the market's perception of the company's ability to create value.<sup>15</sup> In light of the relevance of these issues for investors and of the dramatic falls in stock prices that have affected some companies, there is no doubt that rating agencies will continue to take an even stricter stance as regards these issues in the future.

Ratings thus provide investors with vital information. The independent analysis of the solvency of issuers, the associated rating and any rating changes provide shareholders with invaluable information as to significant components of value creation: the company's ability to generate cash flow in the future, its flexibility, the credibility of its management team, its ability to devise and implement a financial strategy clearly aligned with its operational strategy, the probability of leveraging the existing opportunities for growth, the strategy of distributing value among the various investors, etc.

But this situation is nothing new. How, then, can the increasing power of rating agencies be explained? It is important to understand the reasons behind this development, since, to be effective, all reforms must endeavor to address the causes of a situation, rather than try to limit the impact of any consequences it may have.

The power of rating agencies stems, on the one hand, from a growing shareholder confusion, and on the other, from the very status of the agencies, which makes them critical players and allows them to benefit from almost complete legal immunity.

### *Shareholders at a loss*

The crisis of confidence currently hitting the markets largely results from doubts as to the quality of information provided (both financial and general-purpose information). Faced with the uncertainty surrounding the ways in which value is created<sup>16</sup> and the clear inability of market professionals to respond in this area, investors are plunged into serious uncertainty as regards information. Rating agencies can offer investors a unique point of reference.

However, thanks to leading-edge methods of communication, shareholders have masses of information at their disposal. Private investors are in a far better situation than institutional investors in the previous decade. However, the pace of progress is not quick enough to

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<sup>15</sup> "Les administrateurs peuvent-ils (vraiment) créer de la valeur", J.-F. Rérolle, Business Digest, December 2002

<sup>16</sup> "La création de valeur dans une économie connectée" J.-F. Rérolle, Analyse Financière, September 1998

compensate for three factors, which, taken in combination, have made value creation extraordinarily difficult to assess.

The first factor is the change in competitive advantage.<sup>17</sup> It is only very rarely that companies do not have to confront the following issues:

- New business models that are often less expensive to put in place but have a reduced time life
- The emergence of networks of companies where the value created is collective rather than individual
- The need to forge temporary alliances with competitors with regard to specific aspects of the product/service offering
- An ongoing redefinition of products and services which makes the offering more intangible and pricing strategies ever more difficult to implement
- Continuous technological change which obliges companies to dedicate more and more resources to research and innovation
- The need for companies to cannibalize their own products
- Shorter product design and process life cycles.

In this "hypercompetitive"<sup>18</sup> economy, it is both easier to create competitive advantages (often limited in scope), and more difficult to sustain them. The reduction in the competitive advantage period is a fundamental trend in the contemporary economy.

The second factor is the complexity of organizations that increases the asymmetry of information between companies and investors. Globalization has not been accompanied by an equally rapid convergence of regulations.<sup>19</sup> This has led to the creation of complex legal structures or managerial practices (e.g. transfer pricing mechanisms which lead to blurred responsibilities in global organizations).

The growing importance of intangible assets (key personnel, skills, reputation, research, trademarks, etc.) also heightens the complexity of corporate management. New processes for investment decision, control and compensation must be considered. The management of operational and financial risks should also be fine-tuned. Few companies succeed in managing all such constraints or even clearly identifying those that are deliberately or unintentionally ignored.

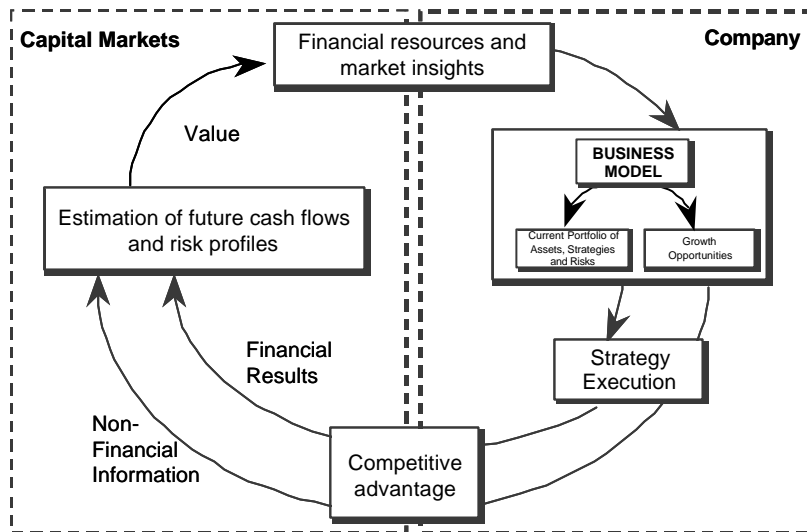
The third factor is the interpenetration of real and financial markets. For a long time, the most important factor was considered to be of an economic nature, according to which a good company strategy would be sufficient for the value of the company's share price to increase. Currently, we know that there is a feedback loop (see below) whereby the market has a direct impact on the value of the company's strategy.

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<sup>17</sup> Note that competitive advantage, which, from a financial perspective, is defined as the company's ability to achieve returns in excess of the cost of capital, is a key component of value creation.

<sup>18</sup> "Hypercompetitive performance : are the best of times getting shorter?", Wiggins and Ruefli, 2001. See <http://www.wiggo.com/Academic/WigginsHypercompetition.pdf>.

<sup>19</sup> Undoubtedly, the European Union has made considerable progress in harmonizing the relevant legislation. Similarly, there is a gradual convergence of accounting standards. However, all this progress remains very slow in comparison with the speed at which major companies are changing.



The financial market receives information (financial and non financial) which allows it to draw up the risk profile and level of profitability required in order to compute share prices. On the basis of available information, including information disclosed by management, investors form an opinion on the growth opportunities created by the company *today*, and likely to be leveraged *tomorrow*.

If investors are convinced that such a portfolio of opportunities exists, their confidence in the future will result in an increase in the company's share price. If the market loses confidence, the company's financial flexibility, and therefore its ability to leverage its future growth opportunities, will shrink.<sup>20</sup> The fall in the stock price will therefore drive down the company's economic value and vice versa.

### *"Decoders" in disrepute*

The confusion in the minds of investors faced with these three fundamental trends can only be heightened by the disrepute or powerlessness of those who were previously responsible for decoding or shedding light on these complex developments.

Let us take discredited company management first of all. Management should be in the best position to reduce the asymmetry of information in the market. But the recent flaws in the system have reminded investors of the need to critically examine groups' financial disclosures, because:

- Management generally tends to be optimistic<sup>21</sup>;
- Only the good news is showcased (bad news is either played down or revealed late in the day);

<sup>20</sup> This crisis will also have an impact on the company's ability to attract new key personnel, which will, in turn, undoubtedly have an impact on the enterprise value.

<sup>21</sup> "Managerial optimism and corporate finance", J.B. Heaton, November 1998. See [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=71411](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=71411)

- In certain cases, we have witnessed manipulation and established fraud that corporate governance systems have been incapable of detecting or have failed to crack down on.

Statutory auditors have shown themselves incapable of changing their role to confront this situation. They have a specifically defined function, which is to attest to the reliability and fairness of financial statements. There is no doubt that their reputation has been affected by recent events. New legal requirements have already been imposed on their practices. Such requirements add to the measures that had already been taken within the profession to enhance the quality of their work, beyond the surveillance performed by the stock market authorities and professional regulatory bodies.

And yet, whatever reforms are introduced, auditors' part in decoding value is necessarily limited: by definition, their approach remains based on historical and financial data, whereas investors also need prospective and non-financial information. Except when it is qualified, the auditor's opinion does not offer investors any new information.

Analysts have long been considered the best decoders of corporate strategies. In fact, their opinions have traditionally been considered as representing those of the "Market",<sup>22</sup> even if research carried out on this topic has shown that analysts mainly react to changes in market value rather than cause them.<sup>23</sup>

Recent events have shown the public what the professionals have known for a long time: analysts' positions (exaggerated by the media) had neither the rigor nor the independence needed to serve the market in a useful manner.<sup>24</sup> Thus, in 1999, out of the 33,169 recommendations made by the 2,200 analysts with respect to 6,000 companies listed in the US, only 125 were recommendations to sell (i.e. 0.37%! ).<sup>25</sup>

In view of the disrepute into which the traditional players in information dissemination and corporate strategy decoding have fallen, it was only natural for the market to listen more attentively to the opinions published by rating agencies.

Furthermore, rating agencies furnish high-quality information. They have privileged access to management and receive confidential information that they undertake, of course, not to disclose to investors. In the US, rating agencies are not subject to the "Fair Disclosure" regulation that prohibits new information from being disclosed in a privileged manner to investors or analysts.

One of the most critical pieces of information which the rating agency may have access to is the business plan which sets out management's expectations in terms of future cash flow. The final analysis is not necessarily based on the assumptions used by the company, but a review of such information makes it possible to better understand its development strategy and offers an important point of reference for monitoring the rating assigned.

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<sup>22</sup> The expression "market consensus" is revealing in this respect.

<sup>23</sup> "What value analysts?", Baruch Lev, Nov 1999, see:  
[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=193428](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=193428)

<sup>24</sup> "Strategic Interactions between Sell-side analysts and the firm they cover", Melvyn Teo, Harvard University, December 2000. See [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=258028](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=258028)

<sup>25</sup> "The Pied Pipers of Wall Street," M. Cole, Bloomberg Press, 2001

Besides the quality of the information used by the rating agencies, the value of a rating is also derived from the independence with which it is given. It is unquestionable that rating agencies have managed to preserve their intellectual integrity despite being generally paid by the issuers they cover.

Several factors have contributed to this situation: the explosion of the bond market which enabled rating agencies to develop without being required to make any specific commercial efforts (either to attract clients or to respond to actions taken by competitors); their financial independence with regard to their clients, none of which provide significant revenues; their rating methodology which is the result of a collective opinion (the rating committee,<sup>26</sup> whose composition and method of functioning aim to guarantee consistency and impartiality).

#### *Corporate governance agents*

The dissemination of information is vital for achieving market transparency. However, there is one function that rating agencies have fulfilled without even noticing: acting as a complement to, and even in some cases a substitute for, management supervisory bodies. In fact, the procedure used and type of decision adopted when assigning ratings to issuers mean that rating agencies participate directly in the supervision of management. This corporate governance function will certainly appear scandalous to some, but in light of the serious flaws that have come to light in the system over the past few years, it may also be seen as a blessing for both shareholders and creditors.

Generally speaking, ratings are assigned at the initiative of companies. Unsolicited ratings have now been abandoned by the two largest rating agencies.<sup>27</sup> Therefore, issuers meet with rating agencies entirely of their own accord, and furnish them with all the information they require to establish the rating.

Ratings are accompanied by an outlook, which may be positive, negative or stable, and which represents the likely trend in the rating over the next two or three years. Except in the event of a new development in the situation, a meeting is usually held with the company on a yearly basis, but the issuer is subject to ongoing surveillance. A rating that is placed under “credit watch” sends signals to the market that a specific event could lead a revision of the rating.

Everything happens as though management had entered into an implicit agreement with the rating agency, whereby it undertakes to achieve a certain level of performance (generating a specified level of cash flow, carrying out restructuring or sales transactions, etc.), which serves as justification for the rating given. In the event that the company does not comply with its undertakings, it runs the risk of its rating being placed under credit watch or being downgraded. This decision would obviously have an impact not only on the cost of its debt, but would also send an extremely negative signal to the financial community.

This function of ongoing management surveillance is particularly effective for three reasons. Firstly, such supervision occurs on a regular basis and may be intensified if needed. Secondly, it is highly technical as is performed by financial experts accustomed to analyzing difficult operational situations. Finally, it carries a clear, public penalty (investors are informed of the downgrade in the rating).

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<sup>26</sup> "Opening the black box: the rating committee process at Moody's", Moody's, July 1999.

<sup>27</sup> Fitch has indicated that it will continue to assign ratings to companies on an unsolicited basis.

It is interesting to compare this supervision with that carried out by the Board of Directors, which is the corporate body in charge of such duties. In many cases, the supervision of the Board is relatively sporadic given the infrequency with which Board meetings are held. Directors often have neither the time nor the technical skills to criticize management's position.<sup>28</sup> Finally, it is very unlikely that management will be sanctioned: most of the directors are executives and in the event of a disagreement, minority shareholders are bound by a duty of discretion.

Aware of their supervisory role, and mindful of the need to improve the understandability of their position, rating agencies are looking at ways to improve their interaction with companies. They are making an effort to be clearer as regards the assumptions they adopt concerning the economic environment, the time periods allotted to companies for meeting certain objectives, the financial and non-financial indicators underlying their decision to place a rating under credit watch, etc.

With this in mind, Moody's has undertaken to be more transparent and suggests that a high-quality document should answer the following questions: What are the main concerns? What are the sources of tension inherent to the rating? Why was a higher or lower rating not given? What could improve or lower the rating? What would be the potential impact on the rating of various scenarios?

This growing involvement of rating agencies in the system of corporate governance is borne out by the decision of Standard & Poor's to launch a specific rating in this respect. The "Corporate Governance Score"<sup>29</sup> expresses S&P's opinion on the principles of corporate governance adopted by companies, but especially on the way in which such principles are applied. These principles cover all possible interaction that may exist between the management, the Board of Directors and all financial stakeholders (shareholders and creditors).

Companies are assigned a general score (not a rating) and specific scores are given for four key areas:

- Ownership structure and influence: this does not merely involve understanding the shareholding structure and its influence on the way in which the company is managed, but also the interaction that may exist between subsidiaries and other related entities (transfer prices, subsidies, advances, etc.)
- Financial stakeholder relations: this aspect is considered in light of the legal system of the country in which the company is operating. In principle, the company must comply with, and even exceed, the requirements of the regulations in force which protect shareholders and creditors. The more sophisticated the legal system in place, the more severe the demands on the company.
- Financial transparency and information disclosure: aside from traditional measures (timeliness, completeness, fairness and clarity), companies are encouraged to

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<sup>28</sup> The Board of Directors could base itself on work carried out by the internal auditors, but such auditors fall under the authority of management. The Board could also call upon the Statutory Auditors who *are* independent, but the matters that they may deal with are limited to accounting issues (and their field of expertise risks being reduced even further by regulations).

<sup>29</sup> "Standard and Poor's Corporate Governance Scores: criteria, methodology and definitions", July 2001

disclose information to the market regarding their operations and competitive position.

- Board and management structure and process: the Board of Directors must be in a position to supervise Management in an independent manner and, hold it accountable to shareholders.

It would appear that this corporate governance scoring service is not yet very developed. It is likely that if the mistrust currently prevalent in the marketplace persists, then it will be in the interests of the best companies to submit to this type of analysis in order to disclose the result to the financial community. It would also serve as a basis for the creditworthiness analysis. In any event, the rating agencies' determination to take this aspect of company management into consideration can only lead to further progress in this matter.

### *Almost complete legal immunity*

These new functions, whereby rating agencies act to reduce the asymmetry of information and conflicts of interest, would never have given as much power to the agencies if their status were not making them inescapable, while at the same time guaranteeing them almost complete legal immunity.

The fact that companies are obliged to use one of the four largest rating agencies derives from their status as NRSROs.<sup>30</sup> This status is awarded by the Securities and Exchange Commission (SEC) according to a certain number of criteria: national recognition, organizational structure, financial resources, size, independence, rating procedures, confidentiality, etc. There have never been more than five agencies with this status at the same time due to successive link-ups in the sector. Currently, three NRSROs control the market:<sup>31</sup> in a market worth USD 2.1 billion, S&P has a market share of 41%, Moody's has 39% and Fitch, 14%. A fourth agency (DBRS)<sup>32</sup> was recently granted this status, but its size is minuscule compared to that of the three majors.

Financial regulators extensively use the ratings assigned by NRSROs as a security criterion applicable to certain investments made by broker-dealers, to insurance companies, pension funds for civil servants, and a large number of other financial institutions. The core US legislation in this area refers to the NRSROs.<sup>33</sup>

The fact that companies are obliged to use these rating agencies is accompanied by the fact that they benefit from almost complete legal immunity. Indeed, the opinions issued by rating agencies are protected by the First Amendment of the American Constitution stating the principle of freedom of expression! An opinion is necessarily subjective and, accordingly, cannot be verified. An opinion cannot be audited, and therefore, cannot be criticized by the US Courts. Rating agencies have thus refused to produce certain documents to the SEC

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<sup>30</sup> Nationally Recognized Statistical Rating Organization.

<sup>31</sup> "The credit rating industry: an industrial organization analysis", L White, 2001. See: [http://papers.ssrn.com/paper.taf?abstract\\_id=267083](http://papers.ssrn.com/paper.taf?abstract_id=267083)

<sup>32</sup> Dominion Bond Rating Services

<sup>33</sup> "Report on the role and function of credit rating agencies in the operation of the securities markets", SEC, January 2003

pursuant to the First Amendment! From a legal standpoint, a rating is therefore similar to a newspaper editorial.

Rule 436 of the Securities Act provides that NRSROs may not be held liable in their capacity as experts pursuant to section 11 and the courts have not tried to hold them liable for other breaches of federal or national regulations. Therefore, there is nothing to suggest that rating agencies may run the risk of being caught up in a legal dispute in the US.

Whenever rating agencies have been attacked, they have won, generally on two grounds: firstly, ratings are opinions that enjoy immunity under the principle of freedom of expression, and secondly, opinions carry qualifications that clearly stipulate that they do not constitute investment advice.

This legal situation is perhaps not as favorable in other countries. However, if a serious threat were to arise in these countries, there would be nothing to stop rating agencies from closing their local offices and continuing to publish their opinions from the US. This is probably the reason why the French Minister for the Economy and Finance recognized that a dialogue needs to be initiated at international level regarding this industry.<sup>34</sup>

#### *Welcome, but insufficient, regulations*

The influence of rating agencies on capital markets has prompted most stock market authorities to consider steps that could be taken in order to limit such influence as far as possible. However, we should not have too many illusions as to the merits of greater regulatory oversight. Steps should obviously be taken, but they would not resolve the problems that caused the situation in the first place.

A review of various debates held within the US Senate<sup>35</sup> and the SEC<sup>36</sup> points to a number of potential reforms. The first such reform would be to encourage competition in the ratings industry by increasing the flexibility of the rule for according NRSRO status. In return, rating agencies seeking to attain such status would have to comply with a certain number of rules, such as the obligation to implement a document retention policy, to provide better information to the market as regards rating rationale, or even to warn the market if a rating is assigned on an unsolicited basis.

Furthermore, we can expect the limitation or prohibition of certain ancillary services which could be seen as a conflict of interests. This is the case with the confidential awarding of ratings according to a number of development scenarios presented by the company or with advice given with respect to risk management.

Finally, it appears that the creation of a professional body, which may be under the supervision of the SEC, is needed. This body would be responsible for monitoring the ethical policy and methodologies applied by rating agencies. It should have disciplinary

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<sup>34</sup> Speech by Mr. Francis Mer to the *Assemblée Nationale* (French parliament) on January 27, 2003.

<sup>35</sup> Financial Oversight of Enron: The SEC and Private-Sector Watchdogs, Report of the Staff to the Senate Committee on Governmental Affairs, October 8, 2002

<sup>36</sup> See <http://www.sec.gov/news/extra/credrate/credrate112102.txt> and <http://www.sec.gov/news/extra/credrate/credrate111502.txt>

power and act as a mediator or arbiter in the event that it were to become aware of serious weaknesses.

The adoption of these measures by the US, but also by the main international financial places, would make it possible to anticipate or resolve the most serious or acute problems. The measures would serve to considerably enhance the industry's reputation, and in doing so, would give even more credibility to rating agencies' opinions.

But if the influence of rating agencies on the marketplace is to be reduced, the real cause should be dealt with: the asymmetry of information between issuers and investors.

### *Market competition*

The influence of rating agencies on the market would not be as significant were this asymmetry of information not as obvious. Indeed, the various measures taken to improve systems of corporate governance and restore credibility to Statutory Auditors or analysts are essential. But they are far from sufficient.

In fact, we have to face the facts: even used responsibly and impartially, the methods adopted by financial experts and analysts are more often than not incapable of evaluating the complexity of the competitive, economic and financial phenomena that companies are up against. Rating agencies are no exception to this rule: the methods of research and analysis available to them are not up to the challenge.

The erratic and unpredictable nature of the markets makes the job of the analysts an impossible one. Indeed, the responsibility for this situation can be thrown onto the irrational behavior of market participants. In this respect, the advocates of behavioral finance<sup>37</sup> claim that investors suffer irrational psychological shifts when making their investment decisions: overconfidence in their capacities and knowledge, an aversion to losses,<sup>38</sup> a tendency to fall into the trap of self-fulfilling prophecies ("I only see what I believe") and to overbid in an irrational manner, the desire to belong to a group (imitation), the inability to assess probabilities rationally,<sup>39</sup> etc.

This situation would justify bringing in an expert who *would* be rational. And yet unfortunately, these behavioral tendencies also apply to stock or credit analysts!

However, despite the markets anomalies, the market remains largely efficient. This efficiency is the most tested assumption in finance and, to date, nothing else has really caused it to be called into question. Complexity science<sup>40</sup> helps us to understand why, although the market is composed of players and observers acting irrationally, it can ultimately behave in a rational manner.

The financial market can be considered as a body composed of the interaction of a large number of agents whose personal strategies change over time according to their success. This mechanism gives rise to certain, so-called "emerging" global features. This is the

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<sup>37</sup> "Human Behavior and the efficiency of the financial system", R. Shiller, January 1998

<sup>38</sup> For an individual, a loss has almost 2.5 times the impact of a gain for a similar amount.

<sup>39</sup> Daniel Kahneman has just been awarded the Nobel Prize for Economics for his work in this field.

<sup>40</sup> "The future of trading: biology-based market modeling at Nasdaq", M. Brown and V. Darley, Perspectives on Business Innovation Journal, issue 4.

concept of the "invisible hand" first described by Adam Smith. As in any complex system, it has the following characteristics: a lack of linearity (effects are not proportional to causes), the existence of critical points (small changes in some factors can have far-reaching consequences, such as market euphoria or market crashes) and the appearance of a feedback loop (the effects magnify the causes).

This approach calls into question the simplistic nature of traditional models: causal analyses or analyses of the links between risk and return are uncertain. Furthermore, there is no point in questioning the players individually as none have the required understanding or science to be useful in understanding the whole picture. Therefore, the coverage or interest of the positions adopted by rating agencies or financial analysts should not be overestimated.

Salvation is to be found in the analysis of the market<sup>41</sup> itself, which still has an essential quality: the valuation of financial securities based on expectations of future cash flow. Naturally, this valuation largely depends on financial and non-financial information, and the signals sent to investors (dividend, investment and financing policies, etc.). While we must accept that the market can make mistakes, its overall efficiency should be recognized.

An accurate valuation is in management's interests. An overvalued company falls into a no-win situation in which it must constantly exceed expectations if it is to progress, until it becomes evident that the frog cannot be as big as an ox. Undervalued, the company is necessarily constrained in its development due to a lack of financial resources.

In order to ensure that markets value companies correctly, management must provide shareholders with enough information to enable them to build up their expectations in a realistic manner. Shareholder expectations may, moreover, differ greatly, which is actually one of the key ways by which excess volatility can be avoided.<sup>42</sup>

Financial information, especially when such information is of a purely historical nature, has never really been able to accurately forecast the company's future. This difficulty is heightened by the change in the economy described above. In order to assess the value of a company, the investors should first and foremost assess the company's ability to create long-term competitive advantages. This can only be achieved by analyzing non-financial indicators.

The analysis of this type of indicator by the market is consistent with the practices of companies who themselves increasingly acknowledge that the use of solely financial measures cannot help them implement their strategy. As Baruch Lev, a professor of accounting and finance in the US argues, to claim that tangible assets should be measured and valued, while intangibles should not is like stating that "things" are valuable while "ideas" are not.

Which non-financial indicators carry the most weight with investors? A study conducted in the US several years ago<sup>43</sup> found that 35% of the investment decision is driven by non-financial information, and that the determining factors in such a decision are based on the

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<sup>41</sup> "Expectations Investing", A. Rappaport and M. Mauboussin, Harvard Business School Press, 2001.

<sup>42</sup> "It's the ecology, stupid. How breakdown in market diversity can lead to volatility", M. Mauboussin, CSFB, September 11, 2000.

<sup>43</sup> "Measures that matter", Ernst & Young, 1997. The findings of this study have been confirmed by other research.

execution of corporate strategy, the credibility of management, the quality of corporate strategy, the ability to innovate, the ability to attract and retain talented people, market share, management experience, the alignment of compensation with value creation, and the quality of the company's main processes.

By providing the market with more information, issuers will allow it to function more effectively without relying too heavily or exclusively on the opinions of rating agencies or analysts.

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### *Directors and market confidence*

The accusations brought against rating agencies are therefore greatly exaggerated. Rating agencies have always played an extremely useful role in informing financial markets and their influence stems primarily from the flaws in our system, rather than a newly rediscovered will to power.

The criticism often directed at them is revealing of the frustration felt by companies in light of the failure (we hope, temporary) of such supervisory bodies to act and their inability to restore investor confidence.

But there should be no mistake about it. Recovery will result from the awareness that it is in everyone's interests to give the market the power we have always recognized in theory and always contested in practice.

The reduction in the asymmetry of information is crucial: without abundant, regular information, the market cannot play its role with respect to evaluating assets and risks and allocating financial resources. Financial reporting is subject to strict regulatory requirements. It is high time for the stock market authorities to turn an eye to non-financial data, the dissemination of which is vital to the investors' decision-making process.

However, rating agencies have also highlighted another problem: management oversight and more generally, the creation and distribution of value. The effectiveness of corporate governance systems has a direct impact on stock prices. In the 1990s, the gap between performance that was measured for a sample of 1,500 companies between the decile of the best corporate governance practices and the worst was calculated at 8.5% per year.<sup>44</sup>

However, Boards of Directors have not known how to intervene or have been unable to do so in order to prevent financial disasters from occurring or merely limit the fall-out. In some cases, observers have been led to wonder if their last-minute activism did not actually make the situation worse.

The proliferation of legal or professional initiatives aiming to respond to shareholder concerns as regards corporate governance are often merely organizational or procedural. They will surely cause more frustration than improvement.

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<sup>44</sup> "Corporate Governance and Equity prices", P. Gompers, J. Ishii, A. Metrick, Wharton, July 2001

In fact, not only do such initiatives offer no guarantee as to the effectiveness of internal control, in which the Board of Directors should play a vital role, but they also very conveniently avoid mentioning the potential power of the control exercised externally by the financial market. This is regrettable, since the solution to the problem involves an enhancement of both these control mechanisms. As the investors' main weapon, the Board will be all the stronger if it has the support of its backers.

In order to deal with the crisis in confidence, the Board must therefore revise its philosophy by working clearly and unambiguously for the shareholder, focusing on value creation and risk management and ensuring that the company does everything in its power to reduce the asymmetry of information.

In a completely remodeled system of corporate governance, rating agencies would maintain their role as independent evaluator of the creditworthiness of issuers, but their opinion would only constitute one indicator among others. They would retain their influence, but their opinion would only be one of several criteria for assessment.

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