

# Kredi Derecelendirme Kuruluşlarındaki Kurumsal Sosyal Sorumluluk: Çatışma Alanları ve Çıkar Çatışması Güvenli Bir Şekilde Nasıl Yönetilir?

Mustafa KAVAS<sup>a</sup>

Kırklareli Üniversitesi

Sinem KALENDER

Kırklareli Üniversitesi

## Öz

Kurumsal Sosyal Sorumluluk, iş dünyasının neredeyse her alanında ilgi çekici bir kavramdır. Son yıllarda özellikle kurumsal skandallar ve küresel finans krizi gibi nedenlerden dolayı kredi derecelendirme kuruluşlarının kurumsal sosyal sorumluluğu üzerinde hararetle tartışmalar yürütülmüştür. Bu kuruluşların mevcut iş modelleri (hisse senedi çıkararak öder) kaçınılmaz olarak bazı çatışma alanlarına ve çıkar çatışmalarına neden olmaktadır. Bu durum bu kuruluşların kaliteli notlar yerine karlarını gözetmelerine sebep olmaktadır. Bu çalışmada, küresel derecelendirme kuruluşlarının ortaya çıkan bu çıkar çatışmasını doğru bir yaklaşımla elimine edebilecekleri veya en azından güvenli bir şekilde yönetebilecekleri savunulmaktadır. Diğer bir deyişle, her ne kadar mevcut durum bu çıkar çatışmasını yönetmenin çok zor olduğunu gösterse de küresel derecelendirme kuruluşları, uygun bir stratejik çözüm benimsedikleri takdirde, bu çatışmaları güvenli bir şekilde yönetebilir.

## Anahtar Kelimeler

Çıkar Çatışması, İş Modeli, İşletme Lisansı, Kredi Derecelendirme Kuruluşları, Kurumsal Sosyal Sorumluluk.

a **Sorumlu Yazar:** Mustafa KAVAS uluslararası ticaret alanında araştırma görevlisidir. Çalışma alanları arasında uygulama olarak strateji, stratejik değişim, yönetsel biliş, pozitif kurumsal bilgi, iş yerinde maneviyat, küçük ve orta ölçekli işletmelerde özellikle Anadolu kaplanlarında strateji oluşturma. *İletişim:* Kırklareli Üniversitesi, Uluslararası Ticaret Bölümü, Kırklareli. Elektronik posta: [mustafa.kavas@klu.edu.tr](mailto:mustafa.kavas@klu.edu.tr)

b Sinem KALENDER uluslararası ticaret alanında araştırma görevlisidir. *İletişim:* Kırklareli Üniversitesi, Uluslararası Ticaret Bölümü, Kırklareli. Elektronik posta: [sinem.kalender@klu.edu.tr](mailto:sinem.kalender@klu.edu.tr)

# Corporate Social Responsibility in Credit Rating Agencies: How to Manage Areas of Conflict and Conflicts of Interest in a Responsible Way

**Mustafa KAVAS<sup>a</sup>**

Kirklareli University

**Sinem KALENDER<sup>b</sup>**

Kirklareli University

## Abstract

Corporate Social Responsibility (CSR) has been an intriguing concept in almost every aspect of business life. In recent years, there has been a heated debate around this concept, especially within the global credit rating agency (CRA) industry, primarily because of recent corporate scandals and the global financial crisis. The current business model ("issuer-pays") of global CRAs inevitably creates some crucial areas of conflict and conflicts of interest that are likely to provoke agencies to value profits over the quality of ratings. In this paper, it is argued that CRAs can eliminate, or at least manage, potential conflicts of interest in a responsible way by implementing true corporate social responsibility initiatives and self-regulating mechanisms. In other words, although the current situation shows that managing conflicts of interest is quite difficult, CRAs have an important role and, if they apply some strategic solutions to such conflicts, they can manage them in a responsible way.

## Keywords

Business Model, Conflicts of Interest, Corporate Social Responsibility, Credit Rating Agencies, License-to-Operate.

**a** **Mustafa KAVAS** is currently lecturer in the Department of International Trade at Kirklareli University. His research interests include strategy-as-practice, strategic change, managerial cognition, positive organizational scholarship, spirituality at work, and strategy formulation in small and medium sized enterprises with a particular focus on Anatolian Tigers. *Correspondence:* Kirklareli University, Vocational School of Social Sciences, Department of International Trade, Kirklareli, Turkey. Email: [mustafa.kavas@klu.edu.tr](mailto:mustafa.kavas@klu.edu.tr)

**b** **Sinem KALENDER** is currently lecturer in the Department of International Trade at Kirklareli University. Contact: Kirklareli University, Vocational School of Social Sciences, Department of International Trade, Kirklareli, Turkey. Email: [sinem.kalender@klu.edu.tr](mailto:sinem.kalender@klu.edu.tr)

*“There are two superpowers in the world today, in my opinion. There’s the United States, and there’s Moody’s Bond Rating Service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful” (Friedman, 1996).*

Credit rating agencies (CRAs) are accepted as among the most powerful and toughest players in the global financial market, particularly because they have been playing a pivotal role in the development of a structured capital market by providing opinions about corporations to individual and organizational investors. A CRA can be simply defined as “a person or organization that issues credit ratings for a reasonable fee; uses a quantitative or qualitative model, or both, to determine credit ratings and receives fees substantially from issuers or investors, or a combination thereof” (Mulligan, 2009). Despite their inevitable power, these agencies have been exposed to intense global outcry and scrutiny in the wake of recent corporate scandals and the global financial crisis. In other words, since they hold the crucial role of eliminating information asymmetries between companies and investors by signaling companies’ creditworthiness, they have been at risk of losing their license-to-operate (corporations’ social acceptance) when they initially give high ratings to a company while it actually has bad performance. Moreover, areas of conflict, inherent in the rating industry, endanger their license-to-operate. However, since the global financial market is more complex than ever before, and borrower diversity has grown over time, both investors and regulators have increased their reliance on the opinions of the CRAs (Cantor & Packer, 1994). In addition, ratings are issued to convey information about those instruments rather than to force investors to buy or sell particular debt instruments. In other words, they do not assess the economic appeal of investments (Rhodes, 1996). However, due to the complexity of analysis of financial instruments, investors tend to rely on these ratings in their investment decisions. What is more, with lower transparency and the oligopolistic nature of the global credit rating industry, capital market participants have little or no choice of eliminating these agencies, even if these agencies lack credibility. That is why we think CRAs have significant power and inevitable effects on global capital markets.

Despite these facts, and their importance within financial markets, global CRAs have remained unregulated private institutions based on the idea of market

efficiency (Rousseau, 2006). Their independence and power have accelerated with the current business model of global CRAs. It is obvious that this business model has led to an outcry over potential conflicts of interest inherent in the rating business, especially with the increase of recent global corporate scandals, such as Enron and WorldCom. For instance, the CRAs who are supposed to provide reliable information to investors might have incentives to hide the truth or ignore due diligence to increase their own profits. Therefore, obviously, the areas of conflict and conflicts of interest inherent in the global CRA industry might be different level. However, because of the space limit, this paper will basically explore conflicts between issuer-focused and investor-focused CRA business models.

In this paper, it is strongly argued that CRAs can eliminate, or at least manage, potential conflicts of interest in a responsible way by implementing true corporate social responsibility (CSR) initiatives and self-regulating mechanisms. In the first section of this paper, we will sketch the evolution of CRA business models, from “investor-pays” to “issuer-pays,” whereby agencies value profits over the quality of ratings. In the second section, basic areas of conflict and various conflicts of interest within this business model will be evaluated. The third section will provide suggestions on how CRAs can handle these areas of conflict and conflicts of interest in a responsible way. Although the current situation shows that managing conflicts of interest is difficult, CRAs have an important role and, if they apply some strategic solutions to such conflicts, they can manage them in a responsible way.

### **Business Model of CRAs: a Shift from “Investor-Pays” to “Issuer-Pays”**

With the dawn of the twentieth century, John Moody developed the first credit rating agency, Moody’s Investors Services, in New York City, with the aim of providing ratings for nearly all of the government bond markets at the time (Setty & Dodd, 2003). Although CRAs first appeared in the United States, nowadays they have a global presence and growing significance (Pinto, 2006). The traditional idea behind publishing ratings has been to provide information

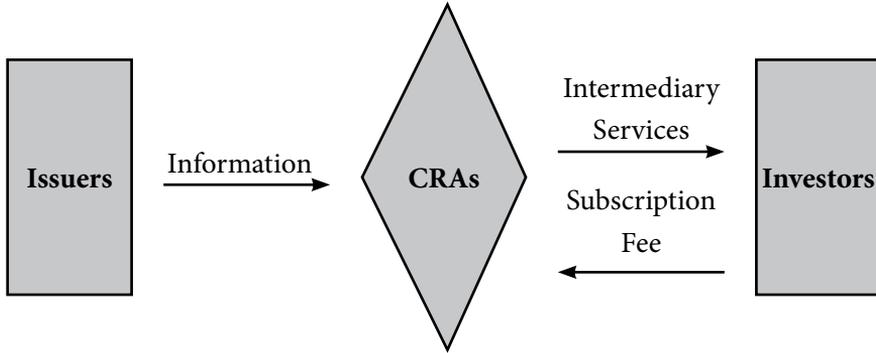
to investors about the creditworthiness of corporate and government bonds (Fons, 2008). The essential function or mission of CRAs has been to reduce information asymmetry within capital markets. It is obvious that they generate revenue from their intermediation services. Initially, they generated revenues mostly from the sales of ratings reports to investors. In this regard, when CRAs first came into place, their main customers were investors. From their inception until the 1970s, CRAs have provided public ratings of issuers and have financed their services solely from the sale of publications to subscribed investors (Cantor & Packer, 1994). CRAs profited by selling their ratings and reports to potential investors who were seeking information about financial instruments. That is why the initial business model was called the “investor-pays,” or “subscriber-pays” model.

With the increase of information technology, such as the development of photocopying in the 1970s, and increasingly complex securities in need of large resources, this practice was rendered unprofitable, because non-subscribers started to receive information for free from the paying subscribers. This led to an increase in CRA concern about declining revenues (Mulligan, 2009). Moreover, agencies started to complain about the “investor-pays” model and insisted upon the necessary shift in the business model because subscription fees were not enough to pay the high-quality staff they required (Strier, 2008).

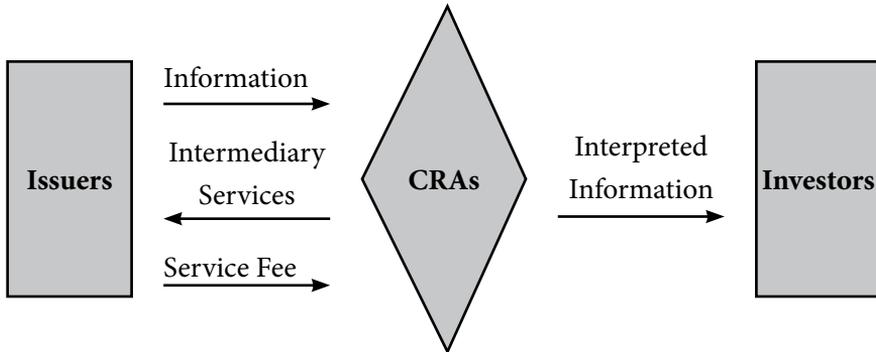
With the increase in CRA complaints, the business model of the credit rating industry shifted significantly from the “investor-pays” to the “issuer-pays” model. Exhibit 1 shows this shift in terms of the change of the structure of relationships among capital market participants.

As can be seen, the “issuer-pays” model shifts the CRAs primary customer base; that is, CRAs now build contractual agreements with issuers not investors, and most of their earnings are generated from that contractual relationship. CRAs still provide intermediation services to investors and issuers in both business models; therefore, they generate most of their revenues from investors in the “investor-pays” model and most of their revenues from issuers in the “issuer-pays” model.

Figure 1: Business model of CRAs: A shift from “investor-pays” to “Issuer-pays” Model (A. “investor-pays” Model [From Early 1900s to Early 1970s])



**B. “Issuer-pays” Model (From Early 1970s to Present)**



As information intermediaries in capital markets, CRAs play an important role because investors lack the expertise and resources to develop a thorough assessment of the sophisticated financial products in which they seek to invest (Mulligan, 2009). In this regard, CRAs are potential sources of information for capital market participants who are trying to ascertain the creditworthiness of issuers. Currently, the main idea behind CRAs, who are private, for-profit companies, is that they make creditworthiness assessment of a particular issuer, which provides CRAs with nonpublic information. CRAs then make their *opinions*, or ratings, about that issuer publicly available in order to give information to potential investors (Strier, 2008). The main purpose of publishing these ratings is to eliminate the information asymmetry between issuers and investors and, thus, better evaluate the quality of corporate bonds (Mulligan,

2009). Besides providing rating services, which depend on contractual relationships with issuers, current global CRAs also issue unsolicited ratings without any contract and offer ancillary services, including rating assessment services, whereby they provide consulting services to advise clients on how a planned corporate actions could impact an issuer's rating (Rousseau, 2006). These aspects of this new business model have raised issues of confidence about the reliability of CRAs, which will be discussed in more detail in the next section.

### **Basic Areas of Conflict and Conflicts of Interest of CRAs**

It is obvious that the rating industry is facing particular areas of conflict, "which arise through the existing tension between profits and ethics" (Lin-Hi, 2010). Although the proper identification of conflicts between profits and ethics in this industry is a crucial challenge, the recent corporate scandals and global economic meltdown brought these areas of conflict under scrutiny. The potential sources of conflicts of interest and basic areas of conflict within the rating industry can be explained as follows:

#### **"Issuer-Pays" Business Model**

As stated above, the most prominent cause of potential conflicts of interest within the rating industry is the current "issuer-pays" business model. The transformation from an "investor-pays" model, in which investors pay for a CRA's services, to an "issuer-pays" model, where issuers pay for these services, causes potential conflicts of interest and jeopardizes the reliability of CRA-issued ratings. The "issuer-pays" business model, therefore, opens the door to potential conflicts of interest in the rating industry (White, 2010). In theory, CRAs should provide investors with independent, accurate, and reliable information in order to decrease information asymmetry through their investment process. However, under the "issuer-pays" model, CRAs are sensitive to their paying clients (the issuers) and consider their needs preferentially. Since CRAs are private and for-profit organizations, they have an obligation to increase their

shareholders' benefits with the goal of maximizing profits. In this industry, it is obvious that issuers prefer high ratings, even if they do not deserve them, in order to appeal to more investors. On the other hand, potential investors seek and want accurate rating information to avoid unwise investment decisions and decrease the probability of payment default (Lynch, 2009). In this regard, as an intermediary between issuers and investors, a CRA clearly has great incentive to *issue ratings inaccurately*, which creates a fundamental and blatant conflict of interest in this industry.

In this model, although CRAs generate some revenue from investors with the sale of more detailed credit analysis and consulting services, approximately eighty to ninety percent of the revenues generated by global CRAs come from issuers (Lynch, 2009). In other words, CRAs have a more potent mutual relationship with issuers because the greater part of their revenues is generated by the issuers. The incentive to give high ratings is innate and is the main area of conflict to emerge in the relationship between rating agencies and their major (issuer) clients that can create a divergence of interests. Although CRAs know that their initial ratings are wrong, they act very slowly to downgrade the inflated ratings. For instance, Enron's bonds were only downgraded by Moody's four days prior to Enron's failure and bankruptcy (Securities and Exchange Commission [SEC], 2003).

In this business model, CRAs also provide ancillary services to the issuers that they rate. For instance, investment banks generally utilize the software provided by CRAs to help them meet the requirements for high ratings, and then pay the agencies to rate these securities. In other words, CRAs are not only paid by the companies they rate, they also work with them through consulting arrangements. The issue here is that these separate consulting fees are extremely lucrative and they constitute a great portion of CRAs' total revenues (Strier, 2008). For instance, the revenue that Moody's Corporation generated from its structured finance consulting services in 2009 was about 40% of its total revenue (SEC, 2010). Therefore, it is obvious that *rating their partners* can be a source of discrete conflict of interest in the rating business. This also means that CRAs are in the position of "auditing their own work" (Mishkin, 2003). Furthermore, in their rating decisions, CRAs can be affected by the likelihood of an issuer

requiring additional ancillary services from them in the future (Rousseau, 2006). This is an obvious reason for the tension between profits and ethics in capital markets. Moreover, modern credit rating agencies provide global investors with an analysis of the risk associated with debt securities, which include corporate bonds, government bonds, municipal bonds, preferred stock, and collateralized securities, such as CDOs (collateralized debt obligations) and mortgage-backed securities (Wolverson, 2010). Since the rating agencies are compensated by the issuers whose CDO bonds they rate, this close relationship creates a potential conflict of interest, which is compounded when the rating agency also consults for the issuers on designing the CDOs (Strier, 2008).

Last, but not least, under the issuer-pays business model, CRAs are responsible for issuing unsolicited ratings based primarily on public information, without any contractual agreement with those companies. In contrast to solicited ratings, which depend on a contractual relationship, unsolicited ratings are generally issued far lower than the ratings issued by other agencies. “By giving borrowers a low, unsolicited rating, the big agencies may force unwilling issuers to pay for their services in the hope of getting a better one” (Economist, 1996). In other words, unsolicited ratings, which are highly controversial, can be used as a deliberate means to increase market share, which presents a potential area of conflict in this business model (Rousseau, 2006).

As an example of this application, in 1993 the Jefferson County (Colorado) School District decided to issue new bonds to take advantage of lower interest rates (Moody’s Investor’s Services, 1999). Although it had hired Moody’s for previous bond issues, it decided to hire Standard & Poor (S&P) and Fitch instead for those particular bonds. Afterwards, Moody published unsolicited ratings about Jefferson County School District expressing a negative debt outlook due to ongoing financial pressures. Thus, although these unsolicited ratings do not reflect the truth, the Jefferson County School District was forced to re-price its bonds at a higher interest rate in order to sell them (Pinto, 2006). In short, these unsolicited ratings can be used as a brutal *retaliation* tool against potential issuers, and thus exacerbates the difficulty of managing conflicts of interest at the agencies.

## Nature of Credit Rating Industry

As stated earlier, the global rating agency industry is highly concentrated and dominated by three major American players, the so-called “Big Three.” Among these players, Standard & Poor’s and Moody’s together hold approximately 80 percent of the market share; Fitch has the bulk of the remainder (Hill, 2002). According to the European Commission, with the three major agencies controlling over 94% of the global market, the credit rating industry is oligopolistic and highly concentrated (European Commission, 2008). This highly concentrated and oligopolistic nature of the industry increases the barriers to entry into this market while simultaneously lacking due diligence in the services that CRAs provide (Tirole, 1988). In other words, these major CRAs strongly maintain their positions within the rating industry, even if their service quality is low. Therefore, it is obvious that the nature of this industry is likely to trigger the inertial attitude among major CRAs, depending on the rigidity of their position within the industry. In the U.S., the current regulatory framework necessitates ratings be issued from a nationally recognized statistical rating organization (NRSRO), as required by the SEC since 1975 (Marzavan & Stamule, 2009). This means that, if a rating agency does not have the so-called “regulatory license” (NRSRO) status, then it would be denied a significant segment of the market. This obviously exacerbates *imperfect competition* and escalates the “natural” barriers to entry into the credit rating industry (Partnoy, 2001). Moreover, this imperfect competition is the main threat impeding innovation in rating services that would normally improve under high levels of competition. This situation is, undoubtedly, another area of inherent conflict found in this industry.

Empirical evidence suggests that conflicts of interest inherent in this industry affect the ratings of major CRAs. For instance, Moody’s stock price tripled between 2003 and 2006 because of its revenue, which was attributed to growth in sub-prime market; in addition, the CEO’s compensation package was doubled in 2006 (Lucchetti, 2007). As shown in Table 1 below, the “Big Three” had steadily increasing turnover and net income, although there were considerable corporate scandals and global crises in the 2000s, such as Enron

and WorldCom. In other words, these major CRAs did not bear the burden of these scandals, in which they played a significant role. Despite the survival of major CRAs and increases in their profitability, global investors and particular issuers fled the capital markets with huge losses, and even bankruptcy. In other words, the economic damage of corporate scandals was suffered mostly by investors and issuers. Inevitably, this table clearly shows that there is an existing tension between profits and ethics that stems from the degree of concentration and the nature of the global credit rating industry.

Table 1  
Key Financial Indicators for the "Big Three" CRAs (in million\$)

	Total Asset	Turnover	Net Income	Opereating Margin	Market Capitalisation	Business Model	Corporate governance	Number of employees
<b>Moody's Corporation</b>						Issuer-pays	Puplicly-owned	
2002	\$630	\$1,023	\$288	28,15%	\$6,899			2,100
2007	\$1,714	\$2,259	\$701	31.03%	\$10,063			3,600
<b>Standard and Poor's</b>						Issuer-pays	Private	
2003	n/a	\$1,700	n/a	n/a	n/a			5,000
2006	n/a	\$2,750	n/a	n/a	n/a			8,500
<b>Fitch</b>						Issuer-pays	Private	
2003	n/a	\$505	\$59.8	11.84%	n/a			1,502
2004	n/a	\$561	\$62.1	11.06%	n/a			1,661

Source: (Cinquegrana, 2009)

### Rating Processes of CRAs

With regard to the simple definition of a CRA, the process of issuing credit ratings is of great importance for the industry. The rating process starts with a request before the issue is offered. The CRA delegates a lead analyst to that issuer to conduct preliminary research and prepare a report about the company, depending on the internal information the company provides. Then, the analyst submits that report to the rating committee, which decides the creditworthiness of the issuer and its financial instruments. After this process, and prior to the rating announcement to capital markets, however, the CRA reviews the rating document with the issuer for factual confirmation and to ensure that no confidential information is disclosed (Rousseau, 2006).

Inevitably, this rating process has its own self-defeating mechanism for the efficiency of capital markets. As such, compensation mechanisms inside a CRA build other areas of conflict that can create a potential bribery threat, agency dilemma, or insider trading opportunity. If there is poor management and a lack of corporate governance within a particular CRA, then the lead analyst is likely to exploit the *bribery* potential in order to gain more interest, even if it reduces the reputation of the entire CRA. Within the rating process, lead analysts are paid according to the volume of ratings they issue, which, in turn, leads to a *lack of due diligence* and *low service quality* (Marzavan & Stamule, 2009). In addition to this area of conflict, since CRAs have access to non-public information about particular issuers, this close relationship with issuers can also lead to *insider trading* that causes the company to buy back its own stock at artificially inflated prices at the expense of individual investors. Since the CRAs know the actual non-public information about companies, they can also use this information to inform their own investment decisions. It can be obviously stated that this can only increase the asymmetry of information, which is mostly detrimental for individual investors within the capital markets.

### **Regulatory Framework**

Throughout history, the credit rating industry has not been heavily regulated. Instead, authorities have generally relied on a self-regulation mechanism. However, in response to the failures of CRAs in the recent economic crises and corporate scandals, authorities have started to introduce new regulations that foster direct government oversight to replace self-regulation, and improve the accuracy of ratings and the integrity of the rating process. However, even with such regulations, the prospect of promoting competition within the rating industry and revising the issuer-pays model is very low (Katz, Salinas, & Stephanou, 2009). Therefore, due to their influential positions within capital markets, CRAs can use inaccurate rating methods to increase their own gains at the expense of others. The recent regulations overseeing the credit rating industry allowed this worrisome situation by failing to penalize incompetent CRAs or to provide incentives to the CRAs to be accurate and ethical in their ratings (Hosp, 2009).

Another important issue with the current regulatory framework is dealing with the First Amendment of the U.S. Constitution, which protects the freedom of speech and the freedom of press. Moreover, in the European Union, the rating agencies have been largely exempt from the established legal standards applied to traditional forms of investment advice (Katz, Salinas, & Stephanou, 2009). Especially with unsolicited ratings, CRAs claim that their ratings are mere opinions not final decisions and judgments; thus, they are protected under the First Amendment (Pinto, 2006). Accordingly, CRAs can exploit this law for their own benefit, as exemplified in the Jefferson County School District case. Last, but not least, although major CRAs operate globally, there is no universally accepted single regulatory framework for the credit rating industry. International inconsistency between regulatory frameworks can easily destroy the international comparability of ratings, exacerbate existing potential conflicts of interest, and deteriorate global financial market efficiency (Utzig, 2010).

All of the aforementioned arguments are potential areas of conflict and conflicts of interest inherent in the rating industry and that lead to increasing public awareness that major CRAs make profits at the expense of ethics. This perception can be shown in Exhibit 2, which indicates that the current positions of major CRAs are under intense global scrutiny, and therefore are at risk of losing their license-to-operate. However, rating agencies—especially major ones—have some counter arguments against these claims.

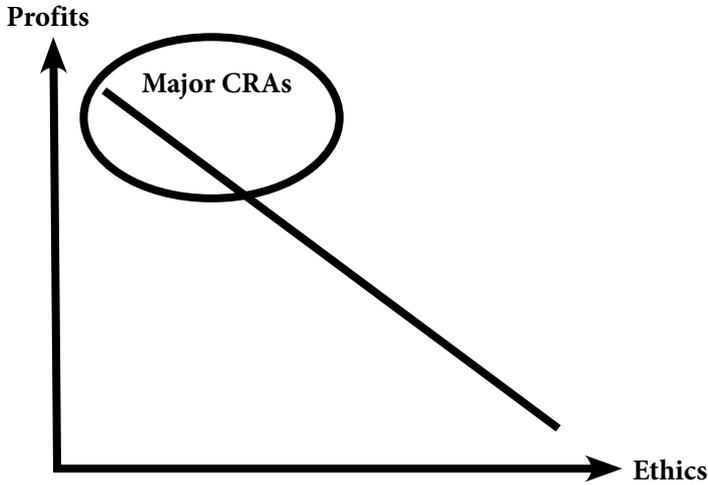
### **CRAs' Defense against Alleged Conflicts of Interest**

Leading CRAs have a specific counter argument against major areas of conflicts and the allegations of conflicts of interest dealing with the “issuer-pays” business model, the nature of industry, and their rating process.

### **Reputational Claims**

The most prominent counter-argument that major CRAs pose to defend their current business model is that the incentive for exploiting potential conflicts

Figure 2: Profits and ethics dilemma in credit rating industry.



Source: Adapted from Course Slides of 'CC 504' CSR Class

of interest is far lower than the importance of their reputation. Contrary to the critics who argue that the current “issuer-pays” model includes potential conflicts of interest within the global credit rating industry, CRAs have claimed that, even if this model creates some areas of conflict and potential conflicts of interest, the survival and the future success of CRAs merely depend on their organizational reputation. According to the industry defenders, if a CRA loses its ratings reliability in the eyes of the investing public, then the market demand for its rating services will be reduced accordingly (Lynch, 2009). In other words, the decrease in the reputation would endanger the future profitability of CRAs (Mishkin, 2003). At first glance, this argument is quite plausible. However, one major factor they overlook is the concentrated and oligopolistic nature of global rating industry. That is to say, even if they lose their credibility, potential issuers do not have many choices to work with. That is why short-term profitability outweighs the need for reputational protection of CRAs in most of their activities (Lynch, 2009). Moreover, empirical evidence provided by Richard Cantor and Frank Packer demonstrates that “the credit rating agencies have been less reliable to absolute risk in that default probabilities associated with specific letter ratings have drifted over time.” Cantor and Packer found

that, within these years, “a relaxation of credit standards may have occurred” (Cantor & Packer, 1994). Therefore, this empirical evidence clearly refutes the reputational claims. In addition to the empirical evidence, the recent sub-prime mortgage crisis has brought significant anecdotal evidence to show how major CRAs exploited their close relationship with issuers at the expense of rating accuracy and overall capital market efficiency (Lynch, 2009).

### **Remedies for Managing Areas of Conflict and Conflicts of Interest in a Responsible Way**

It is obvious that CRAs are under scrutiny and many have started to lose both legitimacy and their license-to-operate. It is of crucial importance for CRAs to take serious actions to regain and protect their positions in the public’s eyes. As stated above, it is obvious that the global credit rating industry has significant areas of conflict and inherent conflicts of interest. It is also important that CRAs, carrying out intermediary roles, have areas of conflict with issuers and investors. In today’s global business world, the main challenge of global CRAs is how to deal with these areas of conflict and conflicts of interest in a responsible way. Inevitably, major CRAs are at the core of this challenge and play an important role because they have significant power over both issuers and investors due to their intermediary roles in capital markets. Although there is not a clear answer about the definition of CSR, it can be simply stated that “CSR is the management of conflicts between profits and ethics” (Lin-Hi, 2010). Considering this fact, and CSR initiatives, in this section we would like to provide some *strategic solutions* as remedies for global CRAs to manage these conflicts in an effective and responsible way.

### **Redesigning the Issuer-Pays Model**

As stated earlier, each CRA business model has potential areas of conflict. Although major CRAs claim that this model does not lead to exploiting conflicts of interest due to reputational pressures and concerns, it is obvious

that this model is under high suspicion as the main reason for such conflicts. As it was once stated, “it’s less about changing the model, and more about improving expectations of what rating agencies do—and don’t do—and what a rating actually means” (Australian School of Business, 2010). The current model serves the well-known one-sided approach of Friedman; that is, “the only social responsibility of business is to increase its profits” (Friedman, 1970). However, in this paper, it is firmly believed that capital markets should not necessarily have to be a zero-sum game; in other words, every player in this business model can benefit in this potential win-win situation. As the most powerful and influential players, CRAs should redesign this model for the sake of all players within this game. In this sense, they can charge not only issuers but also investors. Although it is true that charging investors is difficult, global CRAs should find ways that will balance their relationships with issuers and investors. For this strategic solution, they can, for instance, increase their consulting services for investors or decrease their ancillary services for issuers. Obviously, imitating hands-on and customized consulting services is difficult, and there is no threat of free-of-charge spread of these services among investors, as was the case of the free-rider problem under the “investor-pays” model.

### **Improving Corporate Governance**

Enhancing corporate governance within CRAs will affect the overall industry positively. It should be borne in mind that, without corporate governance, capital markets cannot function well and the remedies discussed here would be obsolete (Mishkin, 2003). On the other hand, as Strier (2008) points out “corporate governance does not necessarily preclude or eliminate a company’s conflicts of interest. Rather, it provides a mechanism for recognizing and addressing them so that they do not corrupt the ethics of the company’s decision making process.” For instance, enhancing a compensation mechanism, which eliminates the bribery probability of analysts in the rating process, would be a good way of managing potential conflicts of interest in a responsible way. For instance, S&P recently adopted procedures to ensure that no individual is able to link credit rating opinions to fees (S&P, 2007). Modification of rating

procedures, such as increasing supervisory oversight in the rating process and introducing performance appraisal systems that are independent of preliminary research, would be another solution for exploiting the conflicts of interest. For example, instead of delegating one lead analyst for conducting the preliminary research, an independent research team can be assigned. The improvement of corporate governance will also increase accountability and transparency, which will decrease the asymmetric information within the industry and mitigate areas of conflict.

### **Building Self-Regulatory Mechanisms**

Although there is a generally accepted belief about the necessity to increase government regulation over major CRAs, it is paradoxical that, as the biggest issuers of debt, governments can create another potential conflict of interest. For instance “what would China say to the U.S. Government rating U.S. government debt?” (Australian School of Business, 2010). Therefore, if government regulation increases, then another player will be included in the existing areas of conflict. Government should enhance competitive mechanisms within the industry (e.g., provide incentives to new entrants). However, the success of any self-regulatory mechanism needs to have an external controlling mechanism that will provide effective supervision and have no direct mutual interest with CRAs. Otherwise, deviations from this mechanism can create further conflicts of interest (Utzig, 2010). Last, but not least, the potential conflicts of interest inherent in the current “issuer-pays” business model can also be managed by building self-regulatory mechanisms. For instance, since CRAs cannot sacrifice their reputation for short-term profits, their reputation is a main factor in their long-term success. Moreover, regarding fair competition, major CRAs can cooperate with each other about not issuing unsolicited ratings, which generally generates a potential conflict of interest.

## **Improving Communication between Issuers and Investors using Web 2.0 Tools**

Transparency and accountability of CRAs are of great importance for managing conflict and conflicts of interest in a responsible way. Since the main idea behind the CRAs is to decrease information asymmetry, holding a bridge position between issuers and investors is its core business. Nowadays, an alternative communication tool is exploring new techniques using Web 2.0. With the rise of blogs, social networks, and online news, investors are accustomed to receiving independent information instantly and accustomed to generating their own relevant content. That is to say, there is an increasing transparency in every part of our lives. Internet media sites, such as YouTube, Facebook, Twitter, blogs, and other digital platforms, are among the best ways to build a close relationship between issuers and today's savvy investors (Nieto, 2009). This is an important caveat for major CRAs who continue to use conventional means of intermediation tools. Introducing these communication tools will obviously decrease the intermediary costs of CRAs and make every player within the capital market more accountable and transparent. Additionally, these tools allow CRAs to easily detect lax diligence by their analysts in their rating process, and therefore eliminate insider trading, bribery, and opaque disclosure probabilities.

### **Conclusion**

It is obvious that, throughout the last decade, global CRAs have encountered profits and ethics dilemmas in many cases. The current business model of CRAs, the nature of the credit rating industry, the applications in the credit rating process, and the regulatory framework are major factors that lead to areas of conflict and conflicts of interest in this industry. These conflicts of interest and recent corporate scandals have escalated the public's perceptions regarding profiteering and poor ethical standards within the credit rating industry and made their license-to-operate questionable.

Ideally, CRAs should perform in such a way that they are impartial, objective, and socially responsible. However, current "empirical conditions," such as

self-interest of individuals within the CRAs, institutions or institutional arrangements, such as regulatory framework and competition, can easily distract these CRAs from their “normative ideals.” This situation clearly decreases the chance for “the social cooperation for mutual advantage” within the rating industry (Lin-Hi, 2008). To manage the existing areas of conflict and conflicts of interest in a responsible way, global CRAs should utilize key remedies, such as redesigning the current “issuer-pays” business model, improving corporate governance, building self-regulatory mechanisms, as well as improving communication between issuers and investors using Web 2.0 tools. They should also bear in mind that this is not necessarily a zero-sum game. In other words, it is obvious that every party within the industry can benefit from existing capital markets. With their significant power in the rating industry, global CRAs should be pursuing a sustainable win–win situation.

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