Holding Global Regulators Accountable: The Case of Credit Rating Agencies

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Credit Rating Agencies (CRAs) are private nonmajoritarian regulators (NMRs) of international capital markets. Ratings of creditworthiness are ubiquitous in financial markets, and in this way they exercise considerable control over the flow of credit. CRAs entail a puzzle for the question of the legitimacy of global regulation. As profit seeking firms, they lack a formal element of coercion. Yet, CRAs are often criticized for wielding illegitimate power. Furthermore, the broad demand for accountability has not had a great effect on how CRAs operate. Thus, there is a persistent mismatch between demand and supply of accountability, an “accountability gap.” By analyzing the accountability gap, this article seeks to enhance the understanding of the nature and the scope of the legitimacy problems of global NMRs. CRAs suggest that the legitimacy problems of global governance extend beyond formal NMRs to informal NMRs and that solutions sometimes are elusive.

INTRODUCTION

Modern democratic governance is confronted with a dilemma. Only by delegating power to nonmajoritarian institutions (NMIs), such as national ministries, regulatory agencies, central banks, and the like, can decision making be effective. But this raises the perennial question of how “government for the people” can be reconciled with “government by the people” (Scharpf 1999, chapter 1).

Nonmajoritarian regulators (NMR) are arguably the most prominent example of the difficulties faced in attempting to balance effectiveness with democratic control. NMRs such as regulatory agencies, antitrust bodies, central banks, or constitutional courts, seem particularly promising for improving the quality of collective decision making by virtue of being independent from elected officials. For the same reason, they also pose the problem of democratic control more sharply.

Whereas Max Weber was convinced that democracy would be ultimately dominated by bureaucracies, today most analysts see the relationship more pragmatically as a trade-off between efficiency and democratic control. The variations in the problems identified and the remedies pro-
posed differ according to specific national traditions. In the United States, NMRs have been controlled by a highly politicized regulatory process. The most pressing problem has, therefore, not been whether NMRs can be politically controlled, but rather, how they can live up to their promises of efficiency (Wilson). Presently, there is a clear dominance of efficiency concerns and a much lesser interest in accountability issues (Behn).

More recently, the Weberian concern about the democratic legitimacy of NMRs has resurfaced. At least three developments are responsible for this renewed research interest. First, new public management reforms raise the question of how the new, more efficient bureaucratic forms can be reconciled with the inherently inefficient democratic accountability (Behn). Second, NMRs have spread from the U.S. to Europe and other parts of the world; wherever they have been introduced recently, there is now less confidence in the effectiveness of mechanisms of democratic accountability. Thus, the question is how democratic control is organized (Thatcher) and whether the interaction between regulators and regulatees are constructive or whether they are becoming similar to the rather dysfunctional legalistic approach of the U.S. (Coen). Finally, confidence in the democratic accountability of NMRs has been eroded by a broad trend toward the internationalization of regulation. National NMRs are joining forces to form transnational governmental networks (Slaughter). Furthermore, many international organizations have become de facto global regulators (Braithwaite and Drahos). Also, private actors are increasingly setting rules at the global level (Cutler, Haufler, and Porter). These three trends put the issue of the NMRs’ legitimacy back on the research agenda.

The present contribution addresses the most challenging item of the new research agenda, the legitimacy of global regulation. Thus far, analyses focusing on this issue have followed a normative approach. Studies have analyzed the practices of governance in light of a model of democratic governance to evaluate whether a form of governance is legitimate or not. The problem with this approach is that in the face of widely differing models of democratic governance beyond the nation-state, it is close to impossible to settle the case. The present chapter seeks to move beyond this status quo by proposing an “empirical turn” in the research on democratic legitimacy. From this perspective, the question is not whether a form of regulation is legitimate according to the criteria of the analyst but rather according to the participant actors. Why do actors challenge the legitimacy of global regulators, how do they do it and to what effect? Such an empirical approach will lead to the discovery of legitimacy problems where they were not expected and equally to a better understanding of the real nature and type of legitimacy issues that global governance raises.

The contribution of this article to this vast research agenda is modest. It consists of a case study of the accountability problems of a specific type of private NMR operating at the global level. Here credit rating agencies
(CRAs) are analyzed as NMRs of financial markets. CRAs, such as Moody’s Investors Service (Moody’s) or Standard & Poor’s, are private firms that charge borrowers for evaluating their creditworthiness and for making that information available to investors in the form of a concise summary, that is, a credit rating. Ratings of creditworthiness are ubiquitous in financial markets, and in this way they exercise considerable control over the flow of credit.

CRAs entail an interesting puzzle for the question of the legitimacy of global regulation. As profit seeking firms, they do not seem to qualify as NMRs, because they lack a formal element of coercion. They do not set legal rules that borrowers are forced to observe. Yet, CRAs are often criticized for wielding illegitimate power. There are continual calls from firms, governments, financial regulators, and the press, to hold rating agencies accountable for their activities. Yet this broad demand for accountability has not had a great effect on how CRAs operate. Thus, empirically, there seems to be a persistent mismatch between demand and supply of accountability—an “accountability gap.”

The CRA’s accountability gap is the puzzle that the present article seeks to address. The accountability gap raises two questions. First, why do CRAs, which are private firms with no formal regulatory competencies, purportedly lack legitimacy? Second, why does the persistent demand for more legitimacy not translate into measures to boost the accountability of the CRAs? By addressing these questions, this article seeks to enhance the understanding of the nature and the scope of the legitimacy problems of global NMRs. CRAs suggest that the legitimacy problems of global governance extend beyond formal NMRs to informal NMRs. Furthermore, in these cases satisfactory solutions to them could be more difficult than hitherto acknowledged.

The structure of the article is as follows. The first section presents a conceptual framework based on the principal–agent terminology that captures the accountability problems salient in global regulation (second section). This is followed by an analysis of how CRAs acquire the coercive force that provokes demands for accountability. The argument is that they have acquired a monopoly position, which is strengthened even further by public financial market regulators using credit ratings (third section). The power of CRAs has given rise to numerous attempts of users of credit ratings to hold them accountable. Surprisingly, no group of actors has been able to hold credit rating agencies accountable on a routine basis. The theoretical framework points to some critical factors for accountability relationships to work that are conspicuously absent in the case of CRAs (fourth section). In the conclusion, the normative consequences of the CRAs’ lack of accountability are discussed. Because CRAs are a case of NMR where no solutions to the accountability problem are in sight, the most promising way to reduce their negative side effects appears to consist of limiting their scope of operation (fifth section).
THE ACCOUNTABILITY OF NONMAJORITARIAN REGULATORS

In this section, an analytical framework is presented to analyze the politics of legitimacy of global regulation. The starting point is the observation that challenges to the legitimacy of NMRs are frequently voiced as demands for accountability. In the mass media, numerous attempts to hold national and global regulators accountable are seen. Often, this is simply a call for punishing someone who is seen to be responsible for a negative outcome. In order to analyze the politics of accountability, it is necessary to go beyond this simplistic notion of “accountability” as the ability to punish.

A suitable starting point for developing the conceptual framework for the analysis of the politics of accountability is principal–agent theory. Principal–agent theory is widely used for analyzing accountability problems (Furubotn and Richter, chapter 5). It was first applied to corporate governance but also later to politics in the area of democratic theory discussing the accountability of government (Przeworski, Stokes, and Manin), of public administrations (Bessette), and, lately, of international organizations (Tallberg). The problem of accountability is considered to be the result of an information asymmetry between the principal seeking to control a self-interested agent. The literature usually concludes that the typical principal–agent problems can be overcome by properly designing the rules governing the relationship.

Principal–agent theory defines “accountability” as a specific type of relationship between actors. Accordingly, in the present article, an accountability relationship is established whenever a principal controls an agent acting on his behalf. An agent is accountable to a principal, if the principal receives information on the actions of the agent, and has the ability to impose sanctions (e.g., Elster; Keohane; Schedler). This basic definition applies to a wide array of different types of accountability problems.

In addition to this basic definition, political scientists consider two additional elements to be important for the analysis of political processes. First, an accountability relationship requires justification (Schedler, 17). This element of normative justification is fundamental; without it accountability relationships would be mere power relationships. One such justification for actors acting as principals is that these actors have either delegated authority to another actor or they are granting them financial support. Second, accountability relationships can be contested. The claim by actors to become principals might not be heeded by the agent. Actors claiming that other actors should be held accountable are “would-be principals” seeking to become accepted principals (Keohane, 140).

In modern democracies, political accountability is always an issue, whenever decision making is collectively binding. Coercive decision makers are held accountable through a variety of mechanisms. Most promi-
nently, political accountability is safeguarded by the mechanism of “democratic accountability” (i.e., voting). However, this is by no means the only way to hold decision makers accountable. In addition, there are other mechanisms of political accountability that are not democratic. A system of checks and balances between different decision makers is a horizontal accountability mechanism.\(^2\) So too is transparency.

Despite the undeniable successes of the principal–agent framework, there is at least one important shortcoming. The principal–agent literature conceptualizes the problem of accountability in a rather narrow way. Accountability relationships are almost exclusively seen as the result of a principal delegating decision-making authority to an agent. For example, when the U.S. Congress authorizes an independent regulatory agency such as the U.S. financial market watchdog, the Securities and Exchange Commission (SEC), to make decisions on its behalf and provides funding, it will also hold that agency accountable. Such acts of delegation are a constituting feature of modern bureaucracies and as such merit attention. However, an exclusive focus on hierarchical delegation does not capture all possible types of accountability relationships. Accountability relationships cannot only be internal (within an organization, within a government bureaucracy), but they can also be external. Such external accountability relationships differ in that the principal is not hierarchically superior to the agent. Contrary to internal accountability relationships, they are not constituted by a transfer of decision rights and material support.

There are at least two types of external accountability relationships. They are both modifications of the basic principal–agent relationship. The first type of external accountability relationship arises when the agent is a trustee. A principal–trustee relationship is established, whenever the principal authorizes an NMR to act on its behalf in order to signal a credible commitment (Majone). For example, governments establish such a principal–trustee relationship when they delegate their power to set interest rates to independent central banks. Governments do so in order to signal that they will not give in to demands from the electorate for low interest rates and thus risk excessive inflation. It is in the logic of such a relationship that the principal does not control the trustee in light of its own preferences. With the next election always around the corner, governments would indeed prefer to trade low interest rates and a booming economy in the short run with excessive inflation in the long run. The raison d’être of independent central banks is to neutralize these preferences in order to make a presumably more sensible long-term macroeconomic policy possible. Thus, by definition, principals cannot hold trustees accountable. But who should control them? From the perspective of conventional principal–agent theory, which rests on internal accountability relationships only, there is no answer to this question. However, in terms of the extended principal–agent framework, there is the possibility of external accountability relationships as well. Indeed, independent central
banks are controlled to a large extent by external accountability holders. In the financial community and beyond there are numerous observers discussing and criticizing decisions on interest rates and putting pressure on central banks to give account of their decisions.

Next to principal–trustee relationships there is yet another modified principal–agent relationship that raises the issue of external accountability. This type of relationship could be called “stakeholder–agent” relationship. In contrast to the former, the latter differs from a standard principal–agent relationship because of a modified role not of the agent but of the principal. An actor becomes a stakeholder when another actor’s choice has an impact on him/her (Keohane). Thus, the accountability of NMRs only is an issue if such regulators set rules that are coercive. If this is not the case, actors that feel adversely affected will simply choose to exit its “jurisdiction.” Only if actors are compelled to follow a rule does the question of legitimacy arise. In this case, stakeholders will seek to become principals with respect to such actors and thus transform them into their agent. In modern democracies, being a stakeholder is one of the prime justifications for democratic participation (Habermas). Thus, for example, nongovernmental organizations have claimed that while the decisions of the World Trade Organization (WTO) have a formidable impact on developing countries, the latter have virtually no say in them. In the language of principal–agent theory, developing countries are identified as stakeholders that should be in a position of principals controlling the WTO as their agent.

Modified principal–agent relationships abound, not least a result of the rise of NMR. Often the legitimacy of political decision making will depend on external rather than internal accountability. It is thus important to acknowledge that external accountability relationships are much more difficult to establish than internal ones. As mentioned, modified principal–agent relationships are all characterized by the fact that they are not constituted by an act of hierarchical delegation and subsequent control. This hampers external accountability relationships in two respects. First, it becomes unclear who qualifies as a principal. It is rather difficult to establish the threshold, above which strong influence actually is “choice determining.” So who is constrained to such an extent that he should have a say? In simple principal–agent relationships, by contrast, identifying the principal is straightforward: the principal is the actor that has either authorized another actor to act on his/her behalf and/or has granted material support to another actor to do so. Second, even if it is possible to determine who the external principal is, the question remains which sanctions he/she could impose on an agent. In an external accountability relationship, the principal cannot threaten the agent to withdraw authorization or material support. Thus, the power of the principal is likely to remain precarious. In sum, given that the identity of the principal and his power resources are ambiguous, external accountability relationships are likely to be much more contested than internal accountability relationships.
The concept of external accountability is of particular relevance for the analysis of global regulation (Keohane). At present, the discussion focuses on the internal accountability relationships of international organizations. The question is whether organizations such as the WTO, the International Monetary Fund (IMF), and the World Bank are bureaucracies out of control or whether they can be controlled by their member states who have authorized these organizations and finance them (Nielson and Tierney). However, the focus on internal accountability problems of global regulation neglects the widespread and more important external accountability problems. Even international organizations can affect nonmember states in numerous ways and thus raise the question of whether and how they should also be accountable to them. For example, regional free-trade agreements such as North American Free Trade Agreement (NAFTA) or the European Union (EU) reduce the chances for outsiders to trade with members. Looking beyond international organizations to the sphere of international politics at large, more problems of external accountability become apparent. One intriguing problem of external accountability is raised by the decision making of states. Whenever state decision making has external repercussions, it may be even more difficult to hold them accountable. The states’ internal accountability to the domestic electorate will be in conflict with demands for external accountability by those affected by the decisions. A good example of this is offered by the unilateralism of the Bush administration. Thus, if other important actors of world politics are taken into consideration, the problem of external accountability becomes more salient.

In the following, this article seeks to contribute to a better understanding of external accountability problems of global regulators by analyzing the case of credit rating agencies. Global CRAs, primarily Moody’s and Standard & Poor’s, are commercial firms determining the creditworthiness of borrowers in financial markets. These CRAs pose an interesting puzzle for the conventional social science wisdom on the legitimacy of global NMRs. As private firms mediating between borrowers and lenders, they should be regarded as solutions to problems of accountability. Yet, more often than not, they are described as powerful actors beyond control, whose accountability should be enhanced. In the following it shall be shown that the extended principal–agent framework can contribute a great deal to solving this puzzle. The accountability of CRAs is a perpetual issue because they rest on external accountability relationships. Furthermore, the case corroborates the hypothesis of the extended principal–agent framework that an exclusive focus on the accountability of international organizations is not justified.

HOW CREDIT RATING AGENCIES ENHANCE ACCOUNTABILITY

According to the standard principal–agent framework, CRAs are not the problem but rather the solution; they enhance the accountability of bor-
rowers. In fact, a credit relationship is a classic example of a principal–agent relationship. A lender needs to ascertain that a borrower will wisely use his investments to generate a return, without excessive risk taking. Yet, a borrower has no incentive to disclose negative information regarding his creditworthiness to the lender, as this will increase the cost of borrowing. This information asymmetry inherent in any credit relationship is redressed by the CRAs. CRAs signal changes in creditworthiness to the lender and thus enhance the accountability of the borrower. For this reason, CRAs are primarily seen to enhance accountability.

Admittedly, the standard view on CRAs also entails a potential accountability problem. Lenders now have to make sure that CRAs make an effort to retrieve and communicate the information that borrowers would want to hide. Presently, this is more than a mere academic problem because of the CRA’s peculiar business model. Although credit ratings are information used by investors, it is not the investors themselves who pay for them. Rather, a corporation or a sovereign borrower in need of capital will pay the CRAs for being rated. This raises the question of whether CRAs compete by offering more favorable ratings to a borrower than a competitor (Smith and Walter). This risk is usually seen to be negligible. The reason for this is that by issuing lax ratings, the CRAs would lose their most vital asset, which is to say their reputation as being neutral information providers. Investors would lose interest and as a consequence, CRAs their customers.

The view that CRAs are policed by their reputation in the market place has been dubbed the “reputational capital” perspective (Partnoy). CRAs themselves have adopted this view. The most prominent voice is probably the oldest CRA, Moody’s. Representatives of Moody’s argue that as private firms they are policed by the market. Only if they can retain an untarnished reputation of providing reliable information on creditworthiness will investors use Moody’s ratings and borrowers pay for obtaining a rating. Furthermore, Moody’s insists that no control beyond the market mechanism is justified. In its view, demands for accountability are a result of a lack of understanding of how the rating business works. CRAs only provide information but, as the legal disclaimer on any of Moody’s publications points out, this information should not be misunderstood as advice to buy or sell a security (Molé 1994). For this reason, Moody’s categorically denies being responsible for any transactions that may be triggered by credit ratings. What is more, additional accountability mechanisms are said to be not only superfluous but a threat to CRAs. Were any of the relevant groups able to hold CRAs accountable, this would subject them to external influence and would undermine their neutrality and ultimately their reputation as information providers.

Moody’s is reluctant to see the “accountability gap” frequently identified with respect to CRAs. Yet it does not deny that its control could be improved. But instead of arguing in favor of more accountability, it suggests that control through the market mechanism should be improved.
The major distortion it identifies is the use of credit ratings for regulation. This forces investors to use ratings, even if they do not believe in their quality, and is an incentive for the regulator to establish an oversight, which threatens to interfere with the autonomy of the CRAs. As a consequence, whenever the SEC—the principal financial market regulator in the U.S.—has sought the views of the industry on various reform projects, Moody’s has argued against the “regulatory abuse” of ratings. It was opposed to the SEC’s project of establishing regulatory oversight over the industry in the 1990s (Molé 1998) and upheld the argument even after the problematic performance of rating agencies during the bankruptcy of Enron, the U.S. energy company (McDaniel). With respect to the use of credit ratings by the Basel Committee on Banking Supervision (BCBS), the rather skeptical conclusion was that “the widespread use of ratings in regulation threatens to undermine the quality of credit over time by increasing rating shopping, decreasing rating agency independence, and reducing incentives to innovate and improve the quality of ratings” (Moody’s, 10).

To conclude, the widely held “reputational capital” view on rating agencies argues that although a lack of control of CRAs can be seen as a problem, the solution is not “more accountability” but rather “more market control.” In the terminology of Hirschman (1970), the CRAs’ control mechanism is and should be “exit,” not “voice.” Conversely, demands for “accountability” are misplaced and unfounded. They simply do not make sense.

CREDIT RATING AGENCIES AS COERCIVE REGULATORS

As rating agencies have increased their importance with globalization, they have been ever more criticized for wielding too much power without being accountable. The frequent claims for more accountability of CRAs is a puzzle. The usual perspective on CRAs is that they do not pose problems of accountability but rather are solutions to the problem of accountability. In this section it shall be shown that CRAs raise questions not only of internal but also of external accountability.

According to the reputational capital point of view, CRAs are not regulators, because they do not seek to influence the structure or the strategies of the borrowers they rate. Furthermore, they are not coercive regulators as credit rating is a mere market operation in which a borrower concludes a contract with a rating agency in order to obtain a rating. Rather, their role in financial markets is seen to be rather modest. They merely provide neutral information on creditworthiness of borrowers—to whom it may concern.

Viewing CRAs as neutral information providers may be adequate for some analytical purposes. However, the reality of credit rating shows that this is a useful simplification at best. Contrary to the standard view, CRAs
often do have an impact on the structure and strategy of borrowers, and furthermore, borrowers find it exceedingly difficult to escape this influence (Kerwer; Sinclair 1994, 1999).

How CRAs Regulate Financial Markets

Viewing CRAs as providers of neutral information misses their role as de facto regulators of financial markets. The criteria CRAs use to evaluate creditworthiness are in effect access rules for financial markets. A high-quality credit rating (“investment grade”) will allow for unproblematic access to the most liquid capital markets whereas a low-quality rating (“speculative grade”) assigns a junk bond status and will in effect exclude a bond from the most liquid markets. The rating also has an influence on the cost of borrowing. It will be lowest for holders of the highest rating (triple A) and will increase as the rating signals higher credit risks. This influence is because of the fact that large investors need to rely extensively on CRAs for screening in transparent capital markets. CRAs are thus de facto regulators of financial markets.

A further aspect of CRAs is that their rules have in fact become compulsory. Although in principle no one is forced to be rated by CRAs, in reality it has become rather difficult to escape their influence. Ever since CRAs came into business in the beginning of the 20th century, their influence on borrowers has continually grown. When John Moody founded the first CRA, its sole purpose was to evaluate bonds issued by firms (at first mostly railway companies) to be traded in the U.S. Since these early days, capital markets have expanded considerably in scope and depth and CRAs have followed suit. A modern CRA such as Moody’s or Standard & Poor’s evaluates the credit risk of a bewildering array of borrowers and/or financial instruments. Thus, in addition to corporations, CRAs also rate banks, universities, municipalities, and regional and national states; next to bonds they evaluate the credit risk of equity, syndicated loans, and derivatives such as asset-backed and mortgage backed securities. Wherever credit risk is involved in financial transactions, CRAs are likely to come into the picture. As a consequence, it has also become more difficult to circumvent CRAs.

Furthermore, CRAs have become coercive by having acquired a monopoly position in capital markets (Cantor and Packer). For access to capital markets, borrowers depend on the services of the credit rating agencies. In many national markets and in the international market, there are only three rating agencies that matter: Moody’s, Standard & Poor’s, and Fitch. It is important to note that firms only have a very limited choice. Usually at least two ratings are required for market access. Furthermore, Moody’s and Standard & Poor’s dominate with Fitch working in specialized markets, especially in the rating of financial service firms. Thus, it is only a slight exaggeration to argue that the “Big Two” form a monopoly in the rating market. CRAs are indeed producing what a
Standard & Poor’s slogan claims: “Powerful Opinions. Authoritative Analysis.” If borrowers follow them they are more likely to gain access to capital markets, and the access is going to be under more favorable conditions. If they ignore them, they risk being excluded.

This monopoly position of CRAs can be explained by the difficulties potential competitors would face to enter the market for credit rating (White, 45–47). Only after credit rating agencies have rated a large number of firms in a comparable fashion does their rating become attractive information for investors. In the initial stages, rating agencies cannot hope to recover the costs of their activity. This analysis is supported by the fact that over the last years, the rating industry has become more concentrated than ever before. Duff & Phelps, a small but noted credit rating agency has merged with Fitch/IBCA to form Fitch, reducing the number of significant agencies from four to three.

Third, CRAs are coercive regulators to the extent that they have become instrumental for public regulation. The use of credit ratings for the purposes of risk regulation started in the United States during the New Deal regulation of the 1930s. This is no surprise, as the first CRA was founded in the U.S. in the beginning of the 20th century. This did not change until the 1980s when the regulatory use of credit ratings spread geographically and can now be found in most countries in the developed world (Estrella, 40–54). In fact, the regulatory use of rating agencies has become an accepted best practice worldwide. For example, the Basel Committee for Banking Supervision (2001) recommends using ratings for defining the capital reserve requirements of banks.

Three types of regulatory requirements for different financial institutions have been designed to vary according to the magnitude of the risk they address (Adams, Mathieson, and Schinasi, 153). First, ratings were used to increase the risk sensitivity of investment restrictions for financial institutions. For example, in order to protect the interest of future pensioners, pension funds are not allowed to invest in a bond rated below “investment grade.” Second, regulators have defined disclosure requirements with reference to credit ratings. A financial institution with risky investments will have to disclose more information about its operation in the reports it must publish on a quarterly basis with the SEC than a firm with a lesser appetite for risk. Finally, U.S. regulators have also defined capital reserve requirements with respect to the credit risk involved. In the U.S., financial institutions, such as commercial banks, investment banks, etc., get a discount on their capital reserve requirement if their transaction partners or the securities in their portfolio have a high credit rating.

Whenever financial regulators use CRAs in regulation, they relinquish control over the regulated entities. Why should public regulators do so? The answer is that they are actually trading control for effectiveness. Using credit ratings for regulatory purposes makes risk regulation more flexible and thus more likely to adequately address risks. Given the dynamics of modern finance, adaptation to risk can only be achieved in
a rather crude way within regulatory categories. For example, financial risk will be smaller within states that are members of the Organisation for Economic Co-operation and Development (OECD) than for non-members. A better way to make risk regulation more sensitive to financial market risk is to use credit ratings instead. They offer a more fine-grained risk estimate and also an estimate that varies over time. As credit risk (and other types of financial market risks) varies over time, so do the ratings. By making regulation more effective in this way, regulators hope to avoid the perverse effect of regulation pushing banks to engage in riskier business just to escape regulation (Estrella 2000). This was one of the main problems of the old style inflexible use of ratings.

The regulatory use of CRAs turns them into quasipublic regulators. The agency’s risk estimates do not only signal the amount of risk involved to investors and thus have an influence on the price level, but they also determine which regulatory measures apply. A financial instrument rated as low risk (“investment grade”) imposes a lighter regulatory burden on an investor than an instrument rated high risk (“speculative grade”). This becomes especially visible in case of a downgrade. Some institutional investors such as pension funds are only allowed to invest in low-risk instruments. Once an instrument is downgraded to speculative grade, pension funds will have to sell the financial instrument in question. In case of a downgrade of debt of foreign countries, this can have a severe effect. Another effect can be that investors need to increase the capital reserves to compensate for the increasing risk.

The regulatory use of credit ratings in the U.S. has repercussions elsewhere. Because the U.S. capital market is the most important in the world, no important borrower can ignore this regulatory setup. This California effect (cf. Vogel) has a choice determining effect for borrowers. The regulatory use of ratings amplifies the negative effects of downgrades for borrowers. Firms and states do not only risk more expensive borrowing costs. Whenever a downgrade bars investors from any further investment, borrowers risk being cut off from capital markets. For example, during the Asian financial crisis, CRAs downgraded Malaysia and by doing so accelerated the outflow of foreign capital; as a reaction Malaysian officials publicly denied the correctness of those ratings.

How CRAs Impact Financial Market Participants

As CRAs are coercive regulators, the question follows of what exactly their impact on financial market participants actually is. What difference do CRAs make for players in financial markets? In the following it shall be shown that their impact mainly varies according to the different types of players. In general, borrowers are much more affected than investors. In some instances, the impact of CRAs does seem to have a choice-determining effect. Players constrained to such an extent are in effect stakeholders and therefore likely candidates for “would-be principals” of
rating agencies. These are the ones that are most likely to pursue strategies of holding CRAs accountable.

CRAs regulate both sides of a credit relationship and therefore affect both investors and borrowers; their impact on the investor is rather modest. After all, ratings are not a judgment about investors. For investors, CRAs are one source of information on the credit risks involved in certain investment opportunities. What is more, investors do not even pay for ratings. As has been mentioned, the costs are borne by the borrower who pays for being rated. In case of a downgrade, investors just have to decide whether to shift their engagement to other investments. Investors only ever feel directly affected when they are being harmed by their failure to predict major defaults, such as Enron. In cases such as these, investors are more likely challenge the rating agencies’ practices.

The strongest influence CRAs exert is on borrowers. Their rules of access do not remain external to the borrowers they rate but rather have a substantial impact on them. Rated borrowers frequently adjust their internal structures and their economic activities to conform to the CRA’s standards of creditworthiness (Kerwer, 300–303). The impact of CRAs is clearly visible, whenever the creditworthiness of a borrower deteriorates leading to a downgrade by a CRA. For firms, a downgrade by a rating agency can lead to restructuring and mass layoffs. For public borrowers such as municipalities and regional governments, and so called “sovereign borrowers,” that is, nation-states, the consequences of a downgrade can be fiscal stress and, as a result, a lower supply of social security and other public goods (Sinclair 1994).

The impact of CRAs on borrowers is more hidden during times of stability. Rating agencies constantly monitor borrowers for any changes that might affect creditworthiness. This exerts a subtle pressure on the management of firms and on governments not to make choices that will adversely affect their creditworthiness. Public companies will anticipate that corporate share buyback programs will not please the rating agencies, and so too will governments know about the CRAs’ opinion on specific reform projects or fiscal largesse in general.

During times of financial market turmoil, this impact becomes more visible. More recently, the Asian financial crisis revealed that the activities of CRAs can have catastrophic consequences. Initially, CRAs failed to spot the upcoming crisis. On the contrary, their fairly high and stable ratings even contributed to the false sense of security. When crisis struck, all the major CRAs rapidly downgraded affected countries such as Korea and Thailand and in so doing aggravated the massive capital flight. This “procyclical effect” in times of financial crisis represents probably the most spectacular impact of rating agencies on borrowers, leaving borrowers with hardly any short-term response (Adams, Mathieson, and Schinas). In the aftermath of the Asian financial crisis, severe austerity programs and other painful restructuring measures were necessary to regain more favorable credit ratings.
To sum up, CRAs have a choice—determining effect, not on investors but on borrowers needing to tap into financial markets. These borrowers can be private firms or public institutions. Its subtle influence during times of market stability is revealed more during financial market crisis.

**HOLDING CREDIT RATING AGENCIES ACCOUNTABLE**

The analysis so far shows that CRAs are coercive regulators. Because of their degree of market penetration, their monopoly position in the market for information on creditworthiness, and their use by public regulators, CRAs have a choice-determining impact on borrowers. The puzzle that needs to be addressed is that in the case of CRAs the demand for accountability is not matched by a concurrent supply. From the perspective of the borrowers, there is a persistent accountability gap. Within the standard principal–agent framework it is impossible to make sense of this phenomenon. Therefore, this section seeks to pursue the insights of the extended principal–agent framework further to analyze the struggle for accountability.

The extended principal–agent framework introduced in section two is useful for analyzing the politics of accountability regarding CRAs in two respects. First, it identifies, which actors qualify for holding regulators accountable. A much wider circle of would-be principals comes into view than within the standard principal–agent framework. Would-be principals are not only actors that have transferred resources to other actors but also actors that are vitally affected by other actors.

Furthermore, the extended principal–agent framework can predict the chances of success of different principals seeking to control an agent. It claims that the accountability challenges vary according to the types of relationships between principal and agent. The framework suggests distinguishing between two different types of potential “would-be principals”—internal and external—and allows the formulation of two different hypotheses about the prospects and problems of accountability relationships. Internal principals are closely linked to the agent either because they have delegated authority to the agent or because they grant material support. This allows them to back up control with the threat of sanctions. External principals, by contrast, do not have the same chance and therefore have a much harder time holding agents accountable. They will have to appeal to internal agents or the broad public in order to sanction them.

In the following subsection it shall be shown that stakeholders seek to hold CRAs accountable. Although the agents, that is, the CRAs, deny that they need to become accountable, stakeholder principals (i.e., borrowers) mostly do in fact demand more accountability. Also, attempts vary indeed to the degree that actors are affected.

So far, the most successful participants in the politics of accountability have been the CRAs themselves. None of the would-be principals has managed to establish routines of accountability accepted by CRAs. In the
case of rating agencies, accountability relationships are contested rather than institutionalized. The predictions of the extended principal–agent framework are that the difficulties of CRAs are a result of the fact that, as stakeholders, borrowers need to construct an external accountability relationship. It will be shown that this is the reason why borrowers have difficulties holding CRAs accountable. Exactly because of this, would-be principals pursue the alternative strategy of activating public actors to hold CRAs accountable. This is a blind alley, however, because the relationship between public regulators is also an external accountability relationship. Therefore, stakeholders resort to politicizing the issue in order to change the rules of the game.

**Stakeholder Strategies and How They Fail: Explaining the Accountability Gap**

In the previous section, several actors have been identified as being affected by CRAs. According to the extended principal–agent framework, these actors could seek to hold CRAs accountable because they are stakeholders. In this section, the actors and the strategies are identified. They confirm the predictions of the principal–agent framework that borrowers are more likely to object than investors because they are more directly affected.

As has been shown, investors are not directly affected by what CRAs do. Most of time CRAs do not have a choice determining effect on investors. Investors are completely autonomous in how they use ratings in their portfolio decisions. Just as the extended principle–agent framework would predict, the relationship between investors and rating agencies is characterized by a certain disinterest on the part of the investors (Interviews, International Monetary Fund and American International Group). As a rule, there is only a concern about the quasimonopoly position that rating agencies enjoy. Investors hope that CRAs are controlled by the possibility that market players will stop using ratings where they are not reliable. Thus, as a rule, investors resort to the market strategy of “exit” rather than the political strategy of accountability through “voice.” This relationship between rating agencies and investors changes in times of major defaults, such as Enron. Investors are likely to complain only when they are surprised by a rapid deterioration of the creditworthiness of an investment (Interview, Cantwell & Company). Only under such exceptional circumstances are investors likely to be more outspoken by challenging the CRAs’ practices.

Borrowers, whether they are public or private, are affected directly by the CRAs as coercive regulators. As pointed out in the previous section, rating changes can have a fundamental impact on the possibility of firms to get access to finance. Each downgrade is a potential source of conflict between rating agencies and firms. As a consequence borrowers have continually challenged the CRAs that judge them, usually by calling into
question the factual basis or the general methodology CRAs have employed to arrive at a rating.

Despite the fact that borrowers of all kinds seek to influence CRAs, they have very little influence indeed. This is surprising. In fact, principal–agent theory would predict that borrowers have a good chance of becoming effective principals. Borrowers pay fees for being rated. This transfer of resources should provide them with effective leverage over how a rating is being carried out. In fact, borrowers should be in the rather comfortable position of an internal principal. However, in this instance, this is not the case. The fact that the borrowers pay for ratings is an anomaly, as the real consumers of this information product are the investors (see, e.g., Smith and Walter). In fact, before the 1970s, investors interested in credit ratings needed to subscribe to newsletters published by CRAs. In the 1970s, this business model came under pressure because ratings were increasingly available for free on the newly introduced electronic communication networks for finance. This is when rating agencies switched to charging borrowers. Despite the fact that this new business model could mean a formal empowerment of the borrowers, CRAs categorically and ostensibly refuse to accept any influence by them. CRAs refuse to entertain informal relationships with firms. Rather, analysts insist that CRAs do not give individual advice to firms on how to improve creditworthiness (Interviews, Moody’s and Standard & Poor’s). Thus, there is not even an informal channel for borrowers to influence their activity. CRAs argue that they depend on providing objective information on the creditworthiness of borrowers. Ratings are only credible, if the borrowers do not influence them. Thus, CRAs seek to distance themselves from the borrowers they rate, in order not to tarnish their reputation for being completely objective. This puts borrowers in a position of external principals that need to find alternative strategies of holding CRAs accountable.

As an alternative, borrowers have resorted to establishing other forms of accountability by trying to turn the problem into a political issue. One obvious addressee for such demands are the U.S. public regulators, given that the global CRAs are all based in the U.S. and that they would be the primary regulators to control CRAs. Furthermore, it is their regulatory use of ratings that has contributed to turning them into coercive regulators affecting borrowers. However, to date no accountability structure has yet been institutionalized. Accountability is ad hoc, for example, through inquiries conducted by the SEC or by the appropriate Committees of Congress (Kerwer). This failure of the relevant regulatory agencies to establish a supervisory regime also implies that public regulators offer no additional leverage to increase the accountability of CRAs.

Again, the extended principal–agent theory explains the structural difficulties that public regulators in the U.S. encounter when they attempt to increase the accountability of CRAs. Once again, the accountability relationship is external, not internal. In fact, the regulatory use of ratings
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is not accompanied by an act of authorization or financial support. CRAs are not government agencies; they are private firms that spontaneously evolved in the market and were not used for regulatory purposes for the first two decades of their existence (Sylla). In comparison with other cases to which principal–agent theory is usually applied, in this case the principal does not create the agent by an act of delegation but faces an existing autonomous organization. The relationship between the regulatory agencies and the CRAs can better be described as a principal–trustee relationship. The advantage of CRAs is to have a measure of credit risk for regulatory purpose that mirrors that of financial market.

Accordingly, regulatory agencies using CRAs for regulatory purposes have no solid power basis through which to hold CRAs accountable. First, abolishing the regulatory use of credit ratings would do more harm to the public regulator than to CRAs. Public regulators would be in the awkward position of having to find a substitute for making their regulation sensitive to financial market risk. CRAs on the other hand would almost certainly not go out of business. They would only lose the legal support of their monopoly position. But barriers to market entry for new competitors would still be high. CRAs need to rate a large number of borrowers for them to be an attractive source of information for the investors (White, 46). Furthermore, the standard public administration solutions to the accountability problem in a principal–agent relationship do not work: Increasing the transparency of how CRAs operate so as to create the opportunities for external scrutiny cannot be implemented easily. Increasing transparency would risk giving away information to competitors, and the increasing influence of borrowers could tarnish the rating agencies’ reputation for neutrality. Therefore, CRAs resist fiercely any attempts to make them more transparent.

Another avenue for holding CRAs accountable would seem to be that of claiming liability for negligent behavior. CRAs are, however, virtually immune to liability claims (Husisian). In court, ratings are seen to be opinions and as such are protected by the Constitution as free speech. This implies that the liability standard to which CRAs are held is not mere negligence but recklessness. This is a very high hurdle for plaintiffs. In fact, to date CRAs have not lost a single court case. This is not likely to change soon, because a stricter liability regime would make it possible for any of the numerous users of ratings to blame CRAs for losses from investments. This would undermine the viability of CRAs in their present form (Husisian, 460).

The lack of firmly institutionalized accountability relationships is a formidable hurdle for national stakeholders. However, it makes it even more difficult for stakeholders outside the U.S. to hold rating agencies accountable. National governments engaged in borrowing through financial market transactions can be severely affected by the judgment of CRAs. Countries that have a different societal setup than the U.S. (e.g., corporatist traditions, strong trade unions, a large welfare state) risk being
penalized by the rating agencies. For example, rating agencies see strong trade unions as a threat to fiscal discipline and therefore as reason for a lower rating. Nonetheless, their influence on rating agencies and their regulatory use is minimal. Other countries would need to influence U.S. regulatory authorities using rating agencies (mostly the SEC), but they themselves do not exactly have a firm grip on rating agencies.

Outside the U.S., strategies to improve the CRAs’ accountability are likely to backfire. Other national regulators seeking to control CRAs risk harming its domestic financial market by driving CRAs out of them. Usually a decision to establish a branch in a foreign country is taken only if a certain degree of independence is granted. An alternative strategy is to exert political pressure. This strategy is also likely to be harmful. For example, after having downgraded Japan, the U.S. rating agencies operating in Japan were summoned before the Japanese parliament’s financial committee to justify their decision (FT 12.06.2002, 3). However, such a move is not an indicator of big leverage of the government over the rating agencies. Imposing sanctions because of a downgrade would jeopardize the reputation of the Japanese government in the financial community. Still, the reaction of the rating agencies would more likely be that they terminate activities in a specific country rather than adapting their operations to public demands.

The influence of states is restricted to instances in which global public regulators seek to promote the use of credit rating agencies. The proposal of the Basel Committee to rely heavily on credit ratings for regulatory purposes at the global level did not succeed because of the resistance of some governments against this arrangement. For example, Germany has successfully curbed the influence of CRAs on German public sector banks, a vital source of finance for small and medium-size enterprises (Meister; Interview, Bundesanstalt für das Kreditwesen).

To sum up, there are numerous obstacles that stakeholders face when trying to hold CRAs accountable. Borrowers and regulators cannot rely on the powerful mechanisms of accountability that have been identified by principal–agent theory. Rather, they need to build external accountability relationships. Yet, they do not succeed because of the powerful justification by CRAs that they are already adequately policed by the market. Stakeholders cannot close the accountability gap they have identified, because they do not have the power to hold CRAs accountable.

CONCLUSION

CRAs are nonmajoritarian regulators of international capital markets. By the standard they are setting, they have major influence on which borrowers get access to capital markets and under which conditions. The pivotal position of CRAs is strengthened by the way the market works and the way CRAs are embedded in regulation and has meant that CRAs have justifiably acquired the reputation of being truly powerful actors.
For this reason, they do raise serious accountability challenges. This is an example of an NMR where neither internal nor external accountability relationships work. Neither public regulators nor financial market participants can hold rating agencies accountable in a routine way. Continual demands exist but they are being challenged—so far successfully—by the CRAs. Accountability relationships remain contested.

The extended principal–agent framework has been rather useful for the analysis of CRAs. First and foremost, the framework allows us to make sense of the demands for CRA accountability. The standard view on CRAs suggests that complaints about rating downgrades are always attempts at “shooting the messenger” for the bad news for which CRAs are themselves not really responsible. Contrary to this, the extended principal–agent framework highlights how CRAs affect borrowers and even regulators. By doing so, attempts to mitigate the impact of possibly wrong judgments on the part of the agencies begin to make sense. Second, the framework has shown how the accountability problems with respect to CRAs differ considerably from the hierarchical relationships typical of public administrations and that they can be analyzed well within the traditional framework. Actors seeking to hold CRAs accountable do so because they are affected by the adverse consequences of how credit ratings work. However, such external principals lack the power basis that internal principals have. Finally, the framework helps to explain why in the case of CRAs accountability relationships have lower chances of being institutionalized and therefore why the accountability relationships are highly contested.

The empirical analysis of CRA accountability also points to a limitation of the extended principal–agent framework. While it is suitable for an empirical analysis of the politics of accountability, it does not offer a normative touchstone for evaluating institutional arrangements. The present analysis is not suited to simply replace a benevolent view of CRAs with a more critical one. Undoubtedly, CRAs bring enormous benefits to the operation of capital markets. Also, their power must not be exaggerated, particularly because their influence varies with capital market conditions. It is stronger whenever borrowing by bonds is a more important source of capital than banks or issuing stocks. Also, CRAs do not exclusively determine the behavior of market participants. Investors sometimes choose not to follow rating agencies, in which case the price of an asset diverges from the price suggested by the credit rating. And sometimes borrowers do resort to practices, such as share buyback programs, which CRAs consider detrimental to a firm’s creditworthiness. Finally, borrowers can adapt more symbolically to CRAs by improving their investor relationships and by decreasing their dependence on borrowing altogether.

The extended principal–agent framework also suggests a way of overcoming the possible negative consequences of the CRAs’ low accountability. An alternative to enhancing the accountability of rating agencies or to
abolishing them entirely is to mitigate the adverse impact of CRAs wherever possible. The BCBS’s reform of its capital reserve requirements for banks is an example of this strategy. By abolishing its original proposal of relying exclusively on CRAs for measurements of credit risk, the potentially negative impact on small banks and the periphery of the financial system will be reduced. Another example of a mitigation strategy would be to improve the CRAs’ performance and avoid the pro-cyclical effect of their forecasts. However, here it is more difficult to envisage a constructive role for public regulators. Yet another mitigation strategy is to increase the variety of financing possibilities available to public and private borrowers in order to make them less dependent on CRAs. A case in point is the attempt in Germany to preserve the public banking sector as an alternative means of finance for small and medium-sized enterprises. Here, the state has a major role to play by establishing an appropriate regulatory framework.

Given the importance of CRAs, the results of the analysis are interesting in their own right. Still, the significance of the analysis might go beyond the case at hand. Wherever global regulation uses NMRs, similar accountability problems are likely to arise. Other examples of such NMRs used for regulatory purposes in the financial sector are the International Accounting Standards Board making accounting rules, and the Basel Banking Committee itself, which makes rules for banking supervision. Another example of NMRs is the United Nations’ Codex Alimentarius Commission setting international food safety standards. These are increasingly being used in the regulation of trade within the EU and the WTO. A comparative research project could identify the accountability challenges that arise in these cases and point out the differences between them.

Despite the analytical leverage of the extended principal–agent framework, the present analysis has some limits. A comparative research project on the accountability problems of NMRs could reveal more challenges and other solutions to accountability problems. For example, a comparison between rating and auditing is useful for a deeper understanding of the particular difficulties faced by regulators in trying to hold CRAs accountable. In contrast to CRAs, in the U.S. global auditing firms are embedded in a system of professional self-regulation, which is in turn supervised by public oversight. This regime has been strengthened since the bankruptcy of Enron. Professional self-regulation is an important component of this regulatory system because it supplies public regulators with standards of best practice with which they can evaluate the performance of such firms. Professional self-regulation is lacking in the case of CRAs. Therefore, no independent standards for evaluating their performance exist. Whereas there are “Generally Accepted Accounting Principles,” there are no “Generally Agreed Rating Principles.” In a comparative perspective, this could turn out to be the crucial reason why public regulators have not succeeded in holding CRAs accountable. Comparing
different NMRs in this way will further refine our understanding of who can hold them accountable for what.

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NOTES

1. For an example of this approach see the recent controversy between David Held and Andrew Moravcsik.
2. For the concept of “horizontal accountability,” see O’Donnell.
3. This is the dominant perspective in institutional economics. Neoclassical economists share this view but are more skeptical of the usefulness of having rating agencies for the operation of financial markets. They question the fact that ratings convey information on credit risks that is not contained in the price of an asset (Steiner and Heinke).
4. Other CRAs so far have been less involved in the politics of accountability. To the extent that they have voiced their opinions, they have largely followed Moody’s. The second major CRA, Standard & Poor’s, defends the integrity of the CRAs along the same lines as Moody’s does. In the more recent past, one major exception has been “Duff and Phelps,” a small CRA seeking to establish itself among the big CRAs. However, this rating agency has merged with Fitch/IBCA and therefore ceased to be an independent voice.
7. For the regulatory use of rating agencies see Partnoy and von Randow.

REFERENCES


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