The Failures of Credit Rating Agencies during the Global Financial Crisis – Causes and Possible Solutions

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Summary: The adequacy of credit ratings is crucial for normal functioning of debt markets. Failures of credit rating agencies have strengthened the negative effects of global financial crisis, generating additional systemic risk. The errors of the agencies can be explained by many reasons as business models, conflicts of interest and absent or ineffective regulation of their activities. To overcome these major problems, we can apply different approaches. The best solution is to improve regulatory practices, combining it with limiting the regulatory status of rating agencies.

Key words: credit rating, rating agencies, financial crisis, regulation.

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Introduction

The development of the global financial crisis put the credit rating agencies (CRA) into the center of discussions regarding the problems of the financial system. Until recently they were considered an instrumental factor for the reduction of information problems of the credit markets and for better investment decisions. The Asian crisis and some big corporate bankruptcies in the beginning of the decade put into question the adequacy of the ratings made. The crash of mortgage bonds that led to concussions on the other financial markets and global recession became the reason to increase the criticism. The agencies that were said to be one of the main culprits for the crisis were accused of acting against the investors’ interests and of generating system risk in their pursuit of greater profit.

The current problems concerning the adequacy of the credit ratings revealed the great importance they have for the normal functioning of the financial markets. For issuers looking for financing they provide access to broad opportunities for financing, lower price for capital and greater trust on behalf of their counterparties. For investors in debt instruments the ratings provide an assessment of their credit risk, by reducing the information asymmetry and thus enabling them to make more efficient decisions. The regulators of the financial markets use the credit ratings in case of refinancing by central banks, determining capital requirements, restricting the permissible investments and many more activities of the financial