International Journal of Economics & Management Sciences

Haron, Int J Econ and Manage Sci 2015, 4:3
DOI: 10.4172/2162-6359.1000233

Short Communication Open Access

The Role Credit Rating Agencies Played in the Financial Meltdown of 2008-2009

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Received date: December 05, 2014; **Accepted date:** February 27, 2015; **Published date:** March 07, 2015

Discuss What Role Credit Rating Agencies Played in the Financial Meltdown of 2008-2009

This is an area dear to the author's heart, so is the role of Auditors in the global economic meltdown of 2008-2009, however, we this must admit that we were blind to the obvious, either for lack of knowledge, complacency, or just good all fashioned greed. The credit ratings of Standard and Poor's, Moody's and Fitch played a key role in the valuing of credit risk and in the explanation of investment strategies [1]. The future role of these agency ratings was further extended with the application of the Basle II accord, which establishes rating criteria for the capital distributions of banks. Given the rather unexpected meltdown in Asian countries and corporations in 1998 and the great upsurge in defaults in the 2001–2002 periods, the timeliness of agency ratings has come under closer inspection and criticism [1]. As late as 2006-2007 surveys on the use of agency credit ratings disclose that some investors believe that rating agencies are comparatively slow in correcting their ratings. A well-accepted description for this perception on the timeliness of ratings is the "through-the-cycle" practice that agencies use [1]. According to Moody's, "through-the-cycle" ratings are steady because they are planned to measure default risk over long investment horizons, I guess their definition of horizon differs from ours, and because they are altered only when agencies are confident that perceived changes in a company's risk profile are likely to be long-lasting [1]. Throughout the short span of a few months in 2008, 14 trillion dollars of highly rated bonds fell into junk-status [2], this surprised the global financial system and accelerated the economic decline. The outcome was the worst rupture of the US financial system since the Great Depression. Credit rating agencies (CRAs) such as Standard and Poor's, Moody's and Fitch in particular have come under intense scrutiny as a result of this disaster, both domestically and internationally, as well as many congressional investigations and government inquiries [2]. This lead to public and academic discussions about CRAs focuses on improving the financial system so that a disaster of this magnitude will not happen again. A significant overtone of industry criticisms contains a sense of ethical impropriety on the part of CRAs and ethical uncertainty about the institutional mechanisms that are presently in place [3]. The rating agencies had been widely criticized for their failures in the 1997 global financial crisis [3]. They had underestimated the risks in East Asia; nonetheless, as they became so large that they could no longer be overlooked, their unexpected downgrading of these assets forced them to be sold by pension-funds and other fiduciaries, and aggravated the problem [3]. They had clearly contributed to market instability. It appeared strange, given this record, that Basle II placed such stress on rating agencies. In the 2007/2008 subprime mortgage crisis, the rating agencies again failed and are, in our judgment, correctly regarded as a critical part of the problem [3].

Discuss What you See as Appropriate Takeover Defenses

Agca and Mansi [4] suggests that with increasing managerial voting rights, the likelihood of takeover declines and takeover premium increases. Likewise, they show that as executive holdings increase, CEOs have robust negotiation power in takeovers, which they use for their own advantage. In addition, they find that companies protected by second-generation antitakeover state laws decrease their use of debt and suggest that impairments to takeovers induce a shift from debt to equity financing [4]. Furthermore, they show that company executives tend to use debt more aggressively when faced with control risk. Moreover, they argue that while employing debt restricts executives and leads to a loss of entrenchment, managers find it beneficial to employ debt to prevent control challenge [4]. Alternatively, there is contrary indication that deep-rooted managers alter their capital structure by taking on more debt or by selling equity as a takeover defense. In addition, there is evidence that firms with entrenched executives or weak stockholder rights use more debt in their capital structure. They argue that firms with weak shareholder rights assume conservative (or safe) investment strategies and as such would benefit from higher leverage [4]. Webb [5] analyzed the degree to which two common measures of corporate governance are related to one another. She used a governance index that measures the number of takeover defenses in the corporation regulations and a unique board of director's index, she presented that these two measures of corporate governance should be regarded as a set rather than as individual components. Moreover, it appears that firms with higher growth opportunities have a stronger relationship between the strength of the board of directors and the number of takeover defenses in the company regulations [5].The results of this study show several implications. First, companies that need to create trust between shareholders and managers through better corporate governance structures may find that the costs of having an independent board of directors and negligible takeover defenses overshadow the benefits [5]. These companies may instead try to find an optimal balance between the two governance mechanisms. Second, growth opportunities should be combined into the firm's selection of governance mechanisms. Firms with more chances for growth, and consequently have higher information asymmetries between shareholders and executives, may find that having a strong board of directors, whose drive it is to monitor the executives, resulting in less takeover risks [5].

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