Gemeinschaftsgüter: Recht, Politik und Ökonomie

Preprints
aus der Max-Planck-Projektgruppe
Recht der Gemeinschaftsgüter
Bonn
2001/3

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Dieter Kerwer

March 2001

Max-Planck-Projektgruppe Recht der Gemeinschaftsgüter, Poppelsdorfer Alle 45,
53115 Bonn
www.mpp-rdg.mpg.de

Standardising as Governance: The case of credit rating agencies[1]

Introduction

Undoubtedly, financial markets constitute a vital mechanism for allocating credit in advanced economies. Their undisputed benefits, however, are accompanied by significant externalities. In fact, the history of financial markets has often been told as an endless series of financial crises, which for their part have had severe effects on economic activities at large (Kindleberger 1996). No wonder that crisis prevention has become an important public policy making goal. If this goal were attained, one would be able to reap the benefits of the market mechanism without having to live with its drawbacks. However, preventing financial crises has been a difficult task for many reasons. One of the most important challenges has been that the domain of the problem is incongruent with the jurisdiction. Whereas crisis prevention is usually organised at the national level, financial crises have an inherent tendency to spill over beyond national borders, even if merely in 'psychological' affects, i.e. in the absence of credit relationships (Kindleberger 1996: 108). The globalisation of financial markets over the last three decades has exacerbated this problem. Financial markets have transformed themselves from the numerous discrete infrastructures of their respective national economies into a single highly integrated autonomous global economic sector characterised by a vast volume of international financial flows (Held et al. chapter 4).

There has been an intensive debate on the political consequences resulting from the emergence of a global financial sector. The main hypothesis has been that it would lead to tight constraints on political action. Financial globalisation has been viewed as bringing the

[1] For helpful comments on a first draft of this paper, I would like to thank Adrienne Héritier, and the participants of the workshops 'Common Goods and governance across multiple arenas' at the Max Planck Project Group in Bonn and 'Politik und Recht unter den Bedingungen der Globalisierung und Dezentralisierung' at the Max Planck Institute in Cologne. The paper profited from presentations at the 12th Annual Meeting of the Society for the Advancement of Socio-Economics and at the meeting of the German Political Science Association (DVPW) in Halle/Saale. I conducted the empirical research during my stay at the 'German-American Center for Visiting Scholars' in Washington D.C. from October 1999 until January 2000. I would like to thank the center and especially Esther Holtermann for generous support. Conversations with other visiting scholars were highly stimulating, especially with Jens Beckert. Experts of the US financial service industry and financial regulators contributed their time generously inspite of very busy work days. Also, I would like to thank Susanne Lütz, Tim Sinclair, and Torsten Strulik, who welcomed me on their turf with extensive written comments on the first version of this paper. Darrell Arnold carefully revised my writing – except for this sentence. Remaining errors of fact or interpretation are my own.

post-war 'embedded liberalism', which allowed national welfare states to domesticate modern capitalism, to an end (Cerny 1994). Furthermore, the regulation of financial markets itself has appeared to become much more problematic. Internationally mobile capital has exposed all national preventive regulation to regulatory competition and subsequently protective standards have experienced a 'race to the bottom' (e.g. McKenzie/Lee 1991). This process was supposedly accelerated as states tried to promote their country's financial sector through competitive deregulation (Helleiner 1994, Cerny 1997). More recently, doubts have emerged, especially with respect to the regulatory constraints resulting from financial globalisation. This revised view starts out with the observation that the increasing integration of global financial markets did not sweep away financial service regulation (e.g. Coleman 1996; Vogel 1997). On the contrary, in many instances increasing global integration was accompanied by a process of 'legalisation' in which informal self-regulatory arrangements were recast in a formal legal mould (Lütz 1998). The collective action problems posed by regulatory competition have been overcome by the principle of "international co-ordination of home country control" (Kapstein 1994). At the international level, states co-ordinate their regulatory activities by minimum standards, which reduces the likelihood of a regulatory race to the bottom (T. Porter 1993, Dale 1996, Steil 1994). Subsequently, these standards are translated into national regulation enforced at the national level; they thus facilitate compromise at the international level. The globalisation of financial markets in the last three decades has given rise to a 'multi-level system', which has even led to increasing levels of protection in some areas.

Research on the dynamics of financial market regulation has thus shown that the constraints resulting from financial globalisation are less severe than initially expected. But it needs to be pointed out that, time and again, hierarchical regulation has successfully adapted risks that underestimate the transformation of governance provoked by globalisation. In many global economic sectors and infrastructures the qualitative change in government has been so significant that it cannot be captured by a mere focus on regulatory dynamics. In many areas global governance is increasingly based on ‘private authorities’, i.e. co-operating firms that can set binding rules for themselves or for others (Cutler/Haufler/Porter 1999). This shift away from the state as a public authority, which was the only agent to legitimately make collectively binding decisions in the past, also involves a change in the nature of the rules used. Private authorities cannot resort to formal law; they typically co-ordinate via rules which rely on superior expertise in order to motivate others to follow them. The effectiveness and the broader consequences of this form of governance still have to be explored.

This paper analyses credit rating agencies as one example of a ‘private authority’ involved in the governance of financial markets. Credit rating agencies such as Moody's or Standard & Poor's are private financial service firms that estimate the credit-worthiness of borrowers or financial instruments (Cantor/Packer 1994). By rating a wide range of different borrowers in accord with the same scale and publishing these risk assessments, they have established an important standard for credit risk. These risk assessments are widely used for making investment decisions in the market place. Furthermore, private credit ratings have been used to make the regulation of financial market risk sensitive – for example – by restricting the investment activities of banks to instruments of low credit risk. Both of these functions of credit ratings have become increasingly important in the last two decades as rating agencies have expanded geographically to cover the whole globe (Estrella et al. 2000: 14-54). As a consequence of this development, a rating agency’s negative judgement on a borrower's credit-worthiness can significantly raise the cost of borrowing for both firms and sovereign states. In spite of the potential severity of the adverse effects of a downgrade, rating agencies will turn a deaf ear to borrowers complaints about incorrect credit risk estimates, because negotiating with borrowers would risk tarnishing the rating agency’s image of being a neutral information provider. As a consequence, despite the fact that rating agencies have become increasingly influential in global financial markets, it is very hard to hold them accountable for their action: rating agencies almost never have to justify their decisions, let alone provide compensation to others for the adverse consequences of their mistakes. The breach between the magnitude of potential damages for borrowers and the possibilities of a remedy gives rise to an ‘accountability gap’. The hypothesis of this paper is that this accountability gap results from using credit ratings as risk measures in regulation designed to limit the risk taking of investors. Thus I argue that regulatory enforcement is the key to the rating agencies’ power, and not their pivotal role in financial markets, as is commonly assumed. Public authority plays a crucial role in constituting private authority for credit rating agencies.

The paper will proceed in the following manner. First, I will introduce a framework inspired by neo-institutionalist organisation theory and then subsequently use that framework to analyse the empirical case of credit rating. It conceptualises governance that is based on expertise as a form of organisational-standard setting, and identifies circumstances under which an accountability gap arises. Second, I will claim that rating agencies are setting organisational standards by defining models and practices conducive to high credit-worthiness. Third, I will show that regulatory enforcement is the main reason for the dominance of the rating agencies’ organisational standard. Fourth, I will present evidence supporting the claim that this leads to an accountability gap, which in turn has adverse consequences for the effectiveness and the legitimacy of this mode of governance. I will conclude by briefly sketching out a larger research agenda for comparatively exploring the preconditions and institutional remedies for the accountability problems of global governance arrangements.

Theory

In the following I shall survey the theoretical approaches to the phenomenon of credit rating by private firms. The lead question is: To what extent do they help to analyse the disconnection between power and accountability? Or in other words, to what extent do they help to analyse the accountability gap? According to the perspective of standard economic theory, there is no accountability gap since the agencies are adequately controlled by reputation. By contrast, critical political economy identifies the accountability problem as a major problem for analysis. This position is used as a starting point to mine neo-institutional organisation theory for a more sophisticated explanation of the accountability gap based on the interaction of public and private authority.

Credit rating as information

Credit ratings provide investors with information on the credit-worthiness of borrowers. For this reason, rating agencies are predominantly defined as information intermediaries. This view also forms the basis for the question that economists have tried to answer with respect to rating agencies: if and in what way does the information on the credit-worthiness of borrowers expressed in the credit ratings enhance the efficiency of financial markets (Steiner/Heinke 1996)? Neo-classical finance theory has tried to answer this question by determining the influence of credit ratings on the price of financial assets. One of the major assumptions in its explanatory models is that all market participants have access to perfect information. In such a world, all the information about credit risk is already mirrored in the price of the assets traded. Additional information enhances efficiency only in those rare instances in which this is not the case, such as when credit ratings effectively disclose insider information. Thus, as a rule rating agencies reduce the efficiency of financial markets because their service is costly without producing tangible benefits. By contrast, neo-institutional finance theory suggests a more benign attitude towards rating agencies. According to this perspective, all credit relationships are characterised by a principal-agent problem. Most importantly, there is an information asymmetry that works to the disadvantage of the principal, the lender. The lack of complete information makes it difficult to assess the credit risk before the credit relationship is established and the control of the borrower afterwards. As compensation, the principal will ask for a risk premium which will increase the cost of the financial transactions. Rating agencies can enhance the efficiency of financial intermediation by reducing the lender's monitoring costs. In economics, the accountability of rating agencies is not a problem. Normally they are effectively policed by the market. Rating agencies have not been exploiting the informational asymmetry between themselves and their users. The reason is that information intermediaries are seen to be particularly vulnerable to a loss of reputation as credible sources of information (Mann 1999). Yet, monitoring by reputation can be less effective in times of financial crisis, when rating agencies start to copy each other in order to avoid being the only one off the mark (Kuhner n.d.). Under normal circumstances, it is not necessary to hold rating agencies accountable, because falling demand and a diminishing reputation are enough to ensure responsiveness.

Credit rating as ideological uncertainty transformation

In political science it is less plausible that intermediaries in financial markets are neutral information providers. The work of Tim Sinclair challenges the conception that rating agencies are just firms selling a specific kind of information to the market (Sinclair 1994). The hypothesis guiding his analysis is that the risk assessment activities of rating agencies cannot remain external to the relation between the borrower and lender; they constitute the credit relationship. With their information on credit risk, credit rating agencies transform the uncertainties of credit relationships into calculable risks. By this they effectively shape the mutual expectations between the creditor and borrower. The validity of rating agencies is partly based on consensus; in so far as there is no alternative to credit ratings in credit relationships, but this knowledge is reinforced by the sanctioning power that the possibility of negative risk assessment (downgrades) confers on them. In this sense, rating agencies have epistemic authority (Sinclair 2000, see also Strulik 2000). Most importantly, this epistemic authority has a political dimension. It justifies financial markets as neutral and efficient means for allocating resources, even though they in fact favour the financal elite and disfavour redistribution. In other words, according to this perspective, and contrary to their self-projected image, rating agencies engage in what could be called 'ideological uncertainty transformation'. It is exactly because this uncertainty transformation is ideological that the lack of accountability is problematic.

The thesis of ‘ideological uncertainty transformation’ highlights the existence and the nature of the power of rating agencies. However, this construction of the accountability problem is problematic for several reasons. First, the criticism of ideology-based uncertainty transformation raises a question that any critical theory needs to consider carefully: what are its evaluation criteria (Habermas 1981)? To make the criticism of intermediation by rating agencies more convincing, a comparison with other types of intermediation would be necessary. The most prominent alternative – bank-based intermediation – is characterised by a more coercive creditor-borrower relationship. In this perspective the subtle distribution consequences of a rating-based intermediation probably do not provide a strong case for increasing public accountability. Second, it is doubtful whether the power of the rating agencies can be explained solely by the fact that there is no alternative to their credit risk assessments. In fact, alternative sources of information on credit do exist, such as credit registers and export credit ratings (Estrella et al. 2000: 55-125). Beyond that, a wide range of sources exist that produce credit-related knowledge; for example, investment funds, banks, professional associations and even academia. It would therefore be hard to demonstrate that in the face of these heterogeneous sources, rating agencies would be able to effectively monopolise the cognitive constitution of the credit relationship. Finally, the most problematic consequence of this analysis is that it does not open a perspective on how the negative effects of intermediation based on rating agencies can be mitigated or overcome. If they are the only source constituting a credit relationship in a disintermediated financial market, questions of institutional design cannot be asked. They have to be accepted as an inevitable fate. Public accountability appears necessary but at the same time utopian.

Credit rating as standardising

In the following, I want to propose an alternative way of dealing with the phenomenon of rating agencies, one that builds on the insights of the international political economy. As will be shown, this allows a better account of the power of the rating agencies and makes it possible to conceive of the accountability problem in a way that does not preclude possibilities for an institutional remedy. For this purpose, I propose further pursuing a slightly different understanding of rating agencies as ‘co-ordination service firms’ which function to ‘set standards of behaviour for other firms” (Cutler/Haufler/Porter 1999; Sinclair 1999). This comparison of the process of credit rating with standardising seems a good lead: on the one hand it preserves the insight that rating agencies are not merely neutral information intermediaries but that they also establish a common understanding of what constitutes credit-worthiness; on the other hand, 'standardising' avoids the connotation that there is an inevitable monopoly, since standards (as opposed to regulations) are not mandatory and often have to compete with other standards.

A cursory glance at the standards literature does not immediately reveal a way in which one could theorise about how 'standards of behaviour' actually make a difference. Admittedly, in the last two decades the process of technical standard setting has become of increasing interest in the social sciences. Formerly seen as a technical and rather unspectacular process of making technical artefacts compatible, standards are now recognised as important rules for constituting markets and establishing large technical infrastructures such as telephone and data networks (e.g. Krislov 1997). Economists have primarily been interested in how technical standard setting affects market processes and under which circumstances they have positive or negative effects on competition (e.g. Kindleberger 2000). Political scientists have been interested in technical standardisation because of its crucial influence on technical development and the possibilities this could offer for political influence. Furthermore, it was acknowledged that standardisation is a form that is well adapted to governance beyond the borders of the nation state (e.g. Genschel/Werle 1993). The research interest following from this has aimed to find out how the state and the economic sector interrelate to produce standards (e.g. Werle 1995). The focus of interest is thus not de facto standardisation in the market place, but the proliferating public-private negotiation systems often called committees, which produce standards. In the spirit of collective action theory, the prime concern is to identify the social dilemma that standard setting in committees has to overcome in order to produce standards (Schmidt/Werle 1998, Abbott/Snidal). However, the research agenda on technical standards has primarily been concerned with the governance *of* standardisation not governance *by* standardisation. The issue of how standards co-ordinate action has been neglected.[2]

[2] The neglect of the issue of action coordination is obvious for technical standards in the market. They have a merely trivial validity because technical standards either solve co-ordination problems beneficial to all or have become de facto standards which no one can escape (e.g. Wey 1999). Admittedly, the form of action co-ordination does play a role in the area of regulatory standards. Research on regulatory competition, for example, tries to identify how different types of regulatory standards (for example product vs. process standards) affect the dynamics of regulatory competition in different ways (e.g. Scharpf 1999). However, regulatory standards are mandatory rules based on the authority of law, not voluntary rules based on the authority of expertise.

In order to gain insight into how standards co-ordinate behaviour, this paper closely follows neo-institutionalist organisation theory. The starting point is a definition of a *standard* as *any rule based on expertise that can be adopted voluntarily*. In this sense standards are "advice given to many" (Brunsson 1999: 114). Examples of such standards are technical standards, the rules of international sports associations, or the OECD's recommendations of how to best run an economy, and many others. It is clear that such a definition aims at a vast area of rule-making in modern society. Standardising in this sense is a mode of governance in its own right (Brunsson 2000). Standardising is similar to hierarchical rule-making in that it can only effectively co-ordinate action if the outcomes are seen to be desirable; it differs in the way this underlying legitimacy for rules is secured. In a world of autonomous actors, the legitimacy of hierarchical rules depends on the authority of the rule setter; and the validity of such rules is restricted to a limited range of actors, e.g. the members of an organisation. But standards depend on the legitimacy of the underlying expertise. Since adopting them is voluntary, they do not have to be limited in application to be acceptable.

Standards, in the sense of expertise-based voluntary rules, not only differ from hierarchical rules, but also from the more conventional understanding of 'standards'. They are not technical standards specifying the desired properties of a technical artefact, nor are they just specifications of the minimum or maximum level of protection or risk defined in regulation, such as environmental emission standards. Rather, the underlying paradigm is that they are rules aimed at promoting certain organisational procedures or structures. Examples of such standards are the management rules developed by the International Standards Organisation (ISO), the European Union's Environmental Management and Auditing System (EMAS), or the OECD's rules on corporate governance. In this paper the term 'standard' only refers to this subset of the whole universe of expertise-based rules. 'Standard' is thus defined as an *expertise-based voluntary rule on organisational structures or procedures* (e.g. Kieser, Spindler and Walgenbach).

Most importantly, seeing standardisation as a mode of co-ordination which sets expertise-based, voluntary rules gives us access to systematic reasons for the accountability gap. Standards face an accountability problem whenever they are hierarchically enforced by a third party. This blurs the clear accountability criteria that usually apply in the pure cases. As a rule, in a hierarchy the top of the pyramid, where the rules are set, is held accountable. In the case of standards, by contrast, the user of a standard is responsible, since per definition the adoption of a standard is voluntary. Whenever standards are made mandatory the legitimacy pattern should shift to the hierarchical model. However, often this is not the case, because third party enforcement is also justified by the legitimacy of expertise. In this case, the standard setter acquires power by third-party enforcement, which is not checked by corresponding accountability: "Even if standardisers bear relatively little responsibility, they may have great power. In such cases standardisation may become a form of fairly strong organisation, with concentrated power but diluted responsibility and little room for complaints" (Brunsson 1999: 124).

Two basic theoretical convictions that underpin this conceptualisation of the accountability problem have to be mentioned. The first is that any type of governance structure can only co-ordinate insofar as it is seen to be legitimate (Brunsson/Olsen 1998: 32). The second is the insight from organisation theory that the discourse producing this legitimacy ("talk") and material decision-making ("action") are as a rule only loosely coupled in order to shield decision-making from the potentially crippling effects of the contradictory normative demands of the environment (Brunsson 1989). When this observation is applied to governance structures in general, it is possible to understand why there is a loose fit between the governance structure and its legitimation. Furthermore, it becomes plausible that a hybrid form of governance, with its inherently higher ambiguity about the nature of its co-ordination, allows an even greater degree of de-coupling of the mode of legitimacy from the mode of action co-ordination.

The last important dimension of this approach to standardisation is that it identifies a particular consequence of the accountability problem in standardising. Since the major responsibility involved in using a standard rests with the user, when he is disappointed the user is less likely to complain to the standard setters and more likely to look for his own errors of judgement. In Hirschman's (1970) terminology, attributing blame to the user will make exit more likely than voice. As a rule, this will deprive standard setters of feed back, because standards are less sensitive to exit than markets (Jacobsson 2000). This drawback of standardisation is even more pronounced whenever standards are hierarchically imposed by a third party. When this is done, the already feeble feed-back mechanism of exit is further weakened, but no corresponding mechanism of voice is established. Thus, neo-institutionalist organisation theory finds the accountability gap problematic for a different reason than critical political economy does. Whereas the latter points to the ideological bias underlying uncertainty transformation, the former points to a low likelihood that errors will be corrected.

Summing up

The theoretical analysis presented has argued for a new approach to analysing the power of private actors in the international economy. It has been demonstrated that, in identifying and explaining an accountability deficit, the neo-institutionalist approach, which sees standards as a form of governance, offers a genuine alternative to an approach based on epistemic authority. First, standardisation is characterised by an accountability deficit because it is hard for standard users to hold standard setters accountable for errors. Second, in accord with this perspective the accountability gap is a problem because it prevents the correction of errors, not because of a hidden ideological agenda. However, it remains to be shown whether this theoretical perspective can be used to cast new light on credit rating agencies. In which ways is it possible for rating agencies to be conceived of as standard setters? This will be shown in the next section. Subsequently, the role of third-party enforcement in rating agencies will be analysed. The argument here is that governmental third-party enforcement is an important reason for the pivotal role rating agencies play in global financial markets. In the next section the nature of the accountability gap will be analysed with a view to the extent to which it is due to government third-party enforcement. The paper will conclude with a consideration of possible remedies to the accountability gap and some theoretical lessons that this case suggests.

Defining a standard of credit-worthiness

Rating agencies set a credit-worthiness standard by publishing the criteria that guide them in the rating process. This standard is based on the in-depth expertise that they have accumulated over nearly one century of observing the determinants of credit risk. It is a highly influential organisational standard defining practices and processes conducive to high credit-worthiness. Borrowers use it to assess the likely consequence of any event on its credit-worthiness and investors use it as a model for their own credit risk assessment activities or to reflect on the validity of the analysis underlying a rating. The standard provides a set of criteria which defines, for a general audience, what credit quality is about and how it can be enhanced.

It is unusual to view rating agencies as being in the business of setting standards. Their most visible output – the rating – is a credit risk assessment of an individual borrower and not a general rule about what is desirable from the point of view of credit-worthiness. Furthermore, rating analysts insist that they are not giving advice to individual customers, because they need to keep their judgements neutral (Interview Fitch/IBCA 12.11.1999). Without denying these obvious facts, in the following I want to present some empirical evidence in support of my claim that rating agencies are *also* standard-setters. In the first section I shall show that the judgements rating agencies make depend on an elaborate set of criteria that define credit-worthiness. In the second section I want to show that this definition is publicly available and acts as an influential, but by no means compulsory expertise-based rule.

Assessing credit-worthiness

Rating agencies claim to rely on several criteria when assessing the "...ability and willingness of an issuer to make timely payments on specific debt or related obligations…" (McGuire 1991: 71). First, ratings depend on a consideration of the common economic environment of different borrowers. As a rule, the rating of a borrower will not be higher than the rating of the country of origin. Second, ratings depend on some properties of the borrower himself. For any type of firm, credit-worthiness depends on the ratio of firm value to outstanding debt (Gordon 1991). The higher the value of a firm's assets, the higher the income flows and the lower all debt obligations, the higher the credit rating is going to be. However, a credit rating goes beyond a selective reading of a firms' accounting statement in that there is an attempt to assess the stability over time and the likelihood of a declining performance under stress. In the process specific factors are more closely examined, for example, the stability of the revenue flows, which is likely to be higher in a public utility operating under the regime of a regional monopoly than in an ordinary commercial firm. These considerations vary in accordance with different types of borrowers such as banks, insurance and utilities companies, etc. The credit risk of public borrowers is another major important category for analysis. The rating of a 'sovereign borrower' is the "measure of the ability and willingness of the country's central bank to make available foreign currency to service debt, including that of the central government itself" (Estebanez 1991, p. 157). This is seen to depend not only on economic factors such as the balance of payments, but also on a host of political factors such as the legitimacy of the political system and past records of crisis management. However, it is claimed that these factors are evaluated strictly according to the effects they have on credit-worthiness, and not according to any political criteria (Estebanez 1991, 160).

The rating agencies' material decision-making criteria could be dismissed as mere window dressing. However, this overlooks that they are essential in order for the agencies to offer an interesting type of information to market participants. As such, credit risk assessments are not unique to credit rating agencies. The analysis of credit risk is the work of any kind of financial institution engaged in lending or investing. In fact, the analysis of credit-worthiness is usually associated with banks, which, over a long historical period, have developed techniques to assess the credit risk associated with their customers as one element necessary for determining the eligibility for and the interest of bank loans. Rating agencies and other institutions are not distinguished for publishing their analyses of credit-worthiness. Many financial service firms do so. What really distinguishes ratings from all other types of credit risk analysis is that they aim to give an estimate of the relative credit risk, no matter what type of instrument or borrower is rated (McGuire 1991: 85f.). The claim is thus that ratings allow a comparison of the credit-worthiness of, for example, a Russian region with an Argentine electricity generator and a US carmaker. And this comparability can only be achieved if rating agencies consistently use one set of assessment criteria.

Another reason for doubting the relevance of the agencies' material decision-making could arise from the heretical conviction that (at least in the agencies' time-frame), prices in financial markets are determined not by underlying fundamentals but rather by the mutual observation of market participants. From this perspective, the claim that rating agencies reduce uncertainty by analysing the fundamentals is not very credible. The agencies may try hard to 'see through the business cycle' in order to keep ratings stable over a period of three to five years (Gordon 1991: 106), but they will base their estimates on clues provided by the market and not on clues culled from their analysis. If this view (which is in stark contradiction with how rating analysts talk and write about their work) were true, the major use of the material decision-making criteria would be in giving post-hoc justifications for rating decisions, especially painful downgrades. This argument once again misses the point: for rating agencies need to provide information that differs from that already available in the market. One of the best ways of securing that the credit risk assessment of rating agencies remains distinct is to base it on another mode of uncertainty reduction. Fundamental analysis is the alternative mode employed by the agencies. For this strategy to work, fundamental analysis need not more 'truly' reflect credit risk than the assessment by the market does. In fact, the material decision-making criteria employed by the agency are probably best seen as time-honoured heuristics that help analysts cope with complexity and not as avenues to the real credit risk. However, as an alternative mode of uncertainty reduction, the material decision-making criteria are consequential for the agencies themselves – and beyond.

Standardising credit-worthiness

Even if it is accepted that rating decisions are based on a common set of criteria, it is not obvious how they could become organisational standards. These criteria are intertwined with the procedures of the credit rating process.[3] Each rating is established by a committee, in which analysts with different expertise are assembled in order to ensure that all the relevant knowledge is represented. Furthermore, all rating decisions are reviewed by a senior analyst from outside the committee who is likely to be especially careful if the ratings differ a lot from those of other agencies. Rating agencies continually monitor themselves by retrospectively comparing their credit-worthiness estimates with statistical data. And finally, the agencies try to draw on local expertise by branching out into international webs. Thus, the expertise involved in a rating is closely linked to the organisational structure. What is more, rating decisions always have a qualitative side that is impossible to formalise (e.g. Hirsch 1996). This tacit dimension of the expertise of rating agencies is another indicator of the embeddedness of rating expertise. Surely then this type of expertise cannot be the basis of a standard?

No doubt, estimating credit risk involves knowledge that is deeply embedded in the organisational structure and cannot be disclosed. However, there can also be no doubt that rating agencies are engaged in wrapping some of the relevant knowledge into the standards of credit risk that become relevant in the capital markets. Along with every rating, the agencies publish a short comment giving reasons for the change. Periodically, they publish methodological outlines that disclose the criteria that are taken into consideration. This type of activity is an integral part of their business because this is important information for both type of users of credit ratings. Borrowers seeking access to the capital markets will want to know in advance the criteria used in evaluating them in order to weigh the benefit against the risk. Investors will want to be reassured that rating agencies have an adequate knowledge about what they are doing. To reach these goals it is not necessary to transfer all the knowledge relevant for the decision. But the fact that this is impossible anyway could be an important precondition for rating agencies active disclosure of some of it: they do not need to fear competitors copying them.

The standard of credit-worthiness established by rating agencies – although sometimes contested – has an important orienting function for the decision making of borrowers and investors alike. The influence on borrowers is more readily noted, since a rating determines the cost of borrowing. The nature of the influence is not straightforward, since there is no obligation to maximise the credit rating all the time. If, for example, by a bold investment, a firm achieves a lower credit rating, it might offset its increasing financing costs in the bond market by making use of a better possibility to raise capital in the equity market (Schmidt 1996, 270-71).[4] However, any borrower will have a strong incentive to monitor his decision-making in the light of the rating agencies' standard of credit-worthiness by asking how it will affect the credit rating. A distinct disciplining effect can be observed in management's decisions. This is especially visible in mergers and acquisitions, which can frequently lead to downgrades and is often interpreted as a negative judgement on the part of the market (Schnabel 1996, p.321-22). The same disciplining effect of the credit-worthiness standard can be observed among 'sovereign borrowers' (Sinclair 1994). If municipalities, regions, or nation-states are downgraded by a rating agency, this can have detrimental effects on their capacity to provide public goods such as social welfare or a public infrastructure. The magnitude of the rating agency's influence on sovereign borrowers is shown by the protest from borrowers if the rating downgrade is seen to be unjustified. At times, government representative even plead for mercy – at least according to the headlines of the financial press (Financial Times Deutschland, 6 June 2000: 19). The existence of the standard of credit-worthiness is also documented by the widespread scepticism among German borrowers about the US rating agencies. German firms are reluctant to seek a rating, not because they fear that they will be treated unfairly, but because the same standards of credit-worthiness will be applied as in the US, which will not take into account the specificity of German corporate governance, etc. Without the existence of such a standard, this concern would be meaningless.

Although the influence of the credit-worthiness standard on borrowers seems to be more pronounced, investors might even be more heavily influenced by it. Today portfolio managers are confronted with an enormous range of choice among different financial products from different countries of origin. In the face of such complexity, portfolio managers have to rely on credit ratings for orientation (Behrenwaldt 1996, p. 294-96). For example, prior to the Asian crisis, institutional investors who only invested a small share of their assets in emerging markets often relied exclusively on credit ratings for information on the credit risk involved because it was too expensive for them to carry out a more sophisticated analysis (Adams et al. 1999). Another good example of the extent to which the rating agencies' standard of credit-

[3] The organisational features of rating agencies seem to be quite similar to the non-hierarchical 'network organisations' found in investment banking (see Eccles/Crane 1988).

worthiness is accepted is provided by the fact that many institutional investors such as mutual funds or pension funds have internal rules that bar them from acquiring debt obligations that are rated below a certain threshold or not even rated at all (e.g. ten Brink 1996, p. 278). In this case, the credit rating agencies' standard of credit-worthiness is built into the organisational routines in such a way that the influence might no longer even be acknowledged by the decision makers. It is likely that the German banks' efforts to reorganise their credit-worthiness-evaluation routines in line with the rating agencies' standards in order to comply with the revised Basel capital reserve requirements will be yet another example of the influence of the credit standard (Frankfurter Allgemeine Zeitung, 29.11.2000, p. 49).

Summing up

So far my argument has been that the credit rating agencies set a standard of credit-worthiness in accord with the major defining elements introduced in the preceding chapter: Their *expertise* is based in their knowledge about credit-worthiness. They provide *organisational rules* in that they define structures and practices conducive to a high credit-worthiness. And finally, somewhat *en passant*, I have mentioned that firms can occasionally decide not to follow them, i.e. compliance is *voluntary*. However, rating agencies do not only standardise. No doubt, rating agencies also rate. So how can we bring rating back into the study of rating agencies? One way is to see rating as establishing the extent to which the standard of credit-worthiness applies. Thus in the world of accounting, auditing would be the analogous activity to rating. This comparison with accounting also reveals an important institutional difference between the two institutions. Accounting and auditing standards are usually set by independent professional associations and drafted as rules, whereas the rating agencies themselves define the standard that they also audit. This lack of differentiation between rule setting and rule verification could possibly account for some of the peculiarities of the case. We will come back to this point in the conclusion.

[4] For a more recent example of firms violating the rating agency's standard of credit-worthiness, see the decision by the European Telecom firms to invest heavily in the new UTMS licences, despite of the fact that this reduced their credit rating (Financial Times, 3.11.2000, p.27).

Third-party enforcement

In financial markets the rating agencies' views of what constitutes credit-worthiness matters. Usually their influence is viewed as resulting from the standard’s importance in guiding the actors through the complexity of the market. However, this view cannot explain why rating agencies would be in so influential, even though there are other sources of information on credit-worthiness (see above). To understand the rating agencies' influential position, it is not enough to just look at what they do. My thesis is that the rating agencies' standard of credit-worthiness counts because it has been adopted in financial market regulation. Third-party enforcement by public regulation makes it mandatory to observe the standard in many instances, and it excludes the use of alternative views of credit-worthiness as a substitute. In the following I want to show how and why credit ratings are being used for regulatory purposes. Subsequently, I want to offer an explanation for why they have become influential well beyond the US, where their use was pioneered in the 1930s. The expansion is not so much to be attributed to the aggressive efforts of US regulators to export the standard of credit-worthiness as to the investors’ desire to access the US capital market and the emulation of regulators around the world for the use of that standard in regulation.

Rating and regulation

The financial market regulators in the US were the first to use the rating standard in regulation designed to mitigate excessive risk-taking in financial markets. Three types of regulatory requirements have been designed to vary according to the magnitude of risk they address (Adams et al. 1999: 153). The rating standard of credit-worthiness was first used to define *investment restrictions* for financial institutions. Already in 1936 US regulators restricted banks to investing in debt instruments which were rated at least 'investment grade'. Other restrictions of this type followed. In the same year the Savings & Loan banks were prohibited from investing in non-investment grade securities. Furthermore, since 1991 'money market funds' have been required to limit their investment to highly rated securities. And in 1989 the investment possibilities of pension funds were extended to include asset-backed securities, so long as they were rated among the three highest points on the rating scale. Basing investment restrictions on the rating standard has considerably increased the risk sensitivity to rules that are based on classification schemes of financial products (von Randow 1996). The latter are not sensitive to risk differentials within one category or to changes over time. A second major use of the rating standard has been to adjust *capital reserve requirements* to the credit risk involved. Since 1975 the SEC has been using ratings to adjust capital requirements for brokers and dealers to their risk exposure. Some higher rated securities are calculated to contribute more to the capital held by the firm, thus reducing the requirement for additional cash reserves. The potential advantage is that such regulation can better address the risks involved and at the same time avoid creating an unnecessary burden for the financial industry involved. Finally, regulators have defined *disclosure requirements* with reference to the rating standard. Since 1982 issuers of highly rated bonds have been able to use simplified forms to register their bonds with the SEC. In 1992 it was decided that asset-backed securities could be exempt from any registration if, among other conditions, they had received a high rating.

Since the regulatory use of ratings seeks to curb excessive risk-taking, it targets the investors or borrowers. Thus, the immediate pressure of third-party enforcement aims at convincing investors to observe the rating agencies' credit standard. However, this obligation in turn creates constraints for lenders as well. If the lenders' credit quality deteriorates below the threshold set by the regulator, the investor is forced to withdraw (Interview International Monetary Fund, October 1999). As a consequence, lenders may find that, due to their low credit-worthiness, they cannot gain access to the funds of the big institutional investors, for example, pension funds. Thus, in order to avoid being excluded from the credit market, lenders have a strong incentive to observe the rating agencies standard of credit-worthiness. This is not to say that credit rating agencies have become dominant in the lenders' decision-making. Yet, if lenders are threatened with being excluded from the market, strong pressure to observe the standard results.

Towards global enforcement

In the last two decades rating agencies have started to influence capital markets world-wide. The traditional US rating agencies now boast a truly global network of offices. Local rating agencies have been founded in several countries. This is not only true for highly industrialised countries; it can also be observed in the emerging economies (Adams et al 1999: 189). Local rating agencies try to capitalise on the fact that they have a more detailed knowledge of the industry than their international competitors. Newly founded rating agencies in Germany, for example, try to exploit their knowledge of the famous *Mittelstand*, the dynamic sector of small and medium-sized enterprises. Their claim to superior local knowledge makes them more attractive to these firms because they can expect to be evaluated in an appropriate manner; and many investors presumably feel that the analysis is superior. However, these local agencies have not challenged the position of the US rating agencies. On the contrary, these local rating agencies often enter into joint ventures with one of the big US rating agencies or are swallowed up by them, as happened in France, when Standard & Poor's took over the French rating agency, "Agence d'Evaluation Financière" (Raimbourg 1990: 31-33). Local rating agencies seem to be an attractive take-over target when they do not exclusively cater to the needs of local investors but also aim at providing international investors with information. Another indicator of the increasing importance is the number of sovereign ratings, i.e. ratings of foreign countries. These ratings are of pivotal importance because they place a ceiling on the credit quality that any other lender can achieve. Moody's reported an increase in the number of sovereign ratings from around ten in the 1980s to nearly 70 in 1999 (Adams et al. 1999: 196). In the same year Standard & Poor's listed 79 sovereign ratings. Furthermore, they have become so active in the emerging economy that their role in this area has come within the purview of the critical inquiry into the causes of the Asian financial crisis.

There are two main reasons why the rating agencies' credit-worthiness standard has become increasingly important beyond the parameters of the US financial markets. The first explanation for the fact that firms all over the world have entered the rating game is that a rating has been a precondition for gaining access to US investors. Since the big US institutional investors are important players in the international capital markets and they can only acquire financial instruments that are rated, the de facto access to international capital markets depends on a rating. This is the most important reason for the rising demand of credit ratings in the Asian market (Adams et al. 1999), but is also an important motivation in OECD countries (see e.g. ten Brink 1996: 278). The export of standards by a wealthy market is a mechanism that has been studied in international trade and has been termed the 'California effect', since California – being an attractive market for cars – managed to impose its strict environmental standards on foreign producers (Vogel 1995).

The second explanation for the increasing influence of rating agencies world-wide is that national regulators have started emulating the use of the rating standard in regulation (Adams et al. 1999: 160f). For example, in Japan regulators started using ratings as access criteria for the bond market in the early 1980s. In the European Union this trend was promoted by the 1993 Capital Adequacy Directive, which specifies that companies should set aside more capital for their non-investment grade holding. By the end of the 1990s this directive had been implemented by most member states. Furthermore, the proposed amendment to the Basel capital adequacy standard refers to ratings as risk measurements. This is going to promote the use of ratings in the regulatory process in all countries with internationally active banks. Even regulators in emerging economies are increasingly using ratings in their liberalised markets. The global diffusion of governmental third-party enforcement is another mechanism increasing the influence of rating agencies.

A common perspective in political economy would suggest that the increasing influence of rating agencies' in the rest of the world is due to the US aggressively exporting its regulatory model in order to ensure the dominance of US agencies, which are likely to rate domestic firms more favourably than foreign firms.[5] However, such an interest-based explanation is not entirely convincing. This is not to say that the US never made an attempt to export its model of regulation based on the rating standard. In fact, the US does support the use of a rating standard for credit-worthiness in the reform of the international reserve-requirement standard. However, due to the opposition from countries that fear disadvantages, it is not going to be mandatory (Financial Times Deutschland, 16.03.2000, p. 30). Furthermore, even if it had been successful, the attempt to export the US model to the international regulatory arena could not explain the influence that rating agencies have already had for some time.

Summing up

There is substantial evidence to support the claim that governmental third-party enforcement is crucial for explaining the dominant position of rating agencies in financial markets. It is important to note the reasons that using a private standard of credit-worthiness in financial regulation is attractive. Using ratings creates flexible rules that automatically adjust to different levels of risk: rules referring to ratings impose lower regulatory requirements if the rating signals a low level of credit risk and vice versa. This flexibility is not just a matter of optional fine tuning – presumably with the goal of lowering the burden for investors – it is essential to avoid regulatory failure. A good example of the effects of inflexible regulation is the aforementioned capital adequacy rule of the Basel Banking Committee. By requiring expensive capital reserves for traditional lending activities, but not for the more recent activities off of the balance sheets, the regulation creates an incentive for banks to shift their business from the former to the latter. Banks have increasingly taken advantage of this possibility for regulatory arbitrage and by that have actually increased the riskiness of their operations (Basel Committee 1999, 26). In order to avoid such perverse effects, it is essential that rules be flexible. Using a private standard offers an excellent opportunity for this. Until

[5] I would like to thank Susanne Lütz for pointing this out to me.

other modes for this are found, rating agencies will probably be instrumentalised by regulators. However, solving the problem of regulatory inertia in this way has its own problematic consequences: the mandatory use of credit ratings makes them less flexible than they would be if they were only a voluntary market standard. This effect of using ratings in regulation shall be analysed in the following section.

Compliance without complaints

The neo-institutionalist theory of standardisation on which this investigation is based holds that third-party enforcement can cause an accountability gap whenever voluntary expertise-based standards are converted into coercive rules. So far, I have argued that the private standard of credit-worthiness defined by the credit rating agencies has become coercive due to the third-party enforcement of regulation. I now want to show that this has not been accompanied by a corresponding increase in accountability in credit rating agencies. Although the standard of credit-worthiness defined by rating agencies has become more consequential for more and different types of lenders, it has not become easier to challenge the rating agencies' decision. The reason for this is that public enforcement weakens the control exercised by competition in the market for credit risk assessment, but it does not offset this effect by establishing an effective supervisory mechanism. The problematic consequence of this is that lenders and borrowers have to live with the errors of rating agencies, while the rating agencies themselves miss out on information that could improve their performance.

The accountability gap

An accountability gap arises whenever there is a breach between the power of a rule-maker and the possibility to attribute blame. Does an accountability gap exist with respect to the rating agencies? Certainly rating agencies decline any responsibility for their decisions: they maintain that their information on credit risks cannot pre-empt financial decision-making but only guide it (McGuire 1991: 83).[6] There are a number of good reasons for this stance. First, investment decisions always have to be related to the entire portfolio. A security with a low credit rating is not necessarily a bad investment, since it promises a higher yield. Second, investment decisions inevitably comprise other risks beyond mere credit risk measured by the credit rating. Additional risks such as exchange-rate risks with foreign investments or

[6] Rating-agency analysts who I have spoken to have frequently stressed this point in personal conversations.

liquidity risks are not included in a rating. For these reasons, rating agencies do not claim that their analysis is exhaustive in any way. To fend off liability claims, every rating and all information published is accompanied by a disclaimer to this effect. So far this has effectively shifted the blame to the user of credit ratings. However, in itself this is not enough to give rise to an accountability gap. In Hirschman's terminology, there are at least two possible ways of reacting to institutional decline: exit and voice. In this case the exit option would mean that lenders and borrowers would rely less on ratings. The other possibility would be to strengthen the voice mechanism, e.g. by establishing a strong supervisory structure or a strong liability regime. Neither of these options has yet been realised.

Limited competition

Instrumentalising the rating standard in regulation adversely affects the market mechanism. Since regulation forces investors and, as a consequence, also borrowers to observe credit ratings, there is no possibility to revert to other sources of information on credit risk. Thus, effective market supervision depends on vigorous competition between different rating agencies. However, competition is at best limited. The recent merger of Fitch/IBCA and Duff & Phelps has reduced the number of rating agencies on the global market from four to three. Given that most lenders need two ratings to gain access to capital markets, not much competition remains. Furthermore, market access for newcomers is difficult because of the ratings' positive network externalities.[7] Only a sufficiently large number of ratings allows investors to compare different types of investment opportunities and to rely on the competency of the rating agency. A new rating agency with few published ratings will find it hard to persuade a borrower of their usefulness, and thus to overcome the threshold of small numbers. As we shall see subsequently, the attempt of the US Securities and Exchange Commission to supervise the rating agencies raises these entry barriers even more.

Limited liability

In theory, liability law could offer a remedy for the limits of market control. However, up til now rating agencies have not been held legally accountable for the consequences of their actions. In the US, credit rating agencies are protected by "freedom of speech" as enshrined in the First Amendment. From a legal point of view, published rating opinions are no different

[7] These arise, when a good is more useful to a user if others use it too. A good example is the telephone, which is useless for a single user and becomes increasingly attractive with the number of persons that can be reached (Furubotn and Richter 2000: 290).

from newspaper editorials (Husisian 1990: 446-455). They are only liable in case of recklessness, not in case of negligence. The high level of protection this offers is demonstrated by the instances in which investors or borrowers have tried to challenge rating agencies in Court (Bottini 1993: 493-495). For example, Orange County has blamed the rating agencies for the unfortunate investment decisions that led to its spectacular financial difficulties (McGraw-Hill 1999). So far no liability suit has been successful. This insulation of the agencies from liability claims is not limited to the US. In Germany the legal situation (although more uncertain) is similar (Ebenroth/Koos 1996). This points to more systematic reasons for the rather generous liability standards. One of the reasons could be that negligence is difficult to prove and/or that the introduction of the negligence standard could threaten the economic viability of the agencies (Husisian 1990: 434-444).

Limited supervision

Besides a liability law, rating agencies could be held accountable if the public supervision strengthened the voice mechanism. Since 1975 the principal financial market regulator in the US, the Securities and Exchange Commission (SEC), has been supervising the agencies. However, so far this supervision has not been effective. At first, the SEC supervised the agencies by a highly informal act of certification. To satisfy regulatory requirements, investors could only refer to the rating of a "nationally recognised statistical rating organisation" (NRSRO). However, the SEC did not establish the criteria on which it based its stamp of approval. In fact, when it first defined the phrase ‘NRSRO’, it just referred to the well established US rating agencies. In response to an inquiry from one of the regulated firms the SEC answered: "with respect to 'nationally recognised statistical rating organisations' no question will be raised by the Division when the following organisations are utilised…: Standard & Poor's Corporation, Moody's Investors Services, Inc. and Fitch Investors Services, Inc." (Securities and Exchange Commission 1975). Thus the SEC was just following the judgement of the market. This practice led to considerable frustration among new (and sometimes foreign) rating agencies seeking the SEC’s recognition as NRSRO. Thus, the CEO of IBCA, a British rating agency which only managed to obtain partial recognition, complained: "I am afraid, I am now completely at a loss as to what system the SEC is using to recognise rating agencies" (Monro-Davies 1990). In 1994 the SEC announced a reform in its procedures regarding the recognition of rating agencies (Securities and Exchange Commission 1994). As a result, to safeguard fairness, it is now possible to appeal the case when recognition has been denied. In order to make the application process more transparent, the SEC plans to formalise the recognition criteria by introducing an explicit definition of the term NRSRO (Securities and Exchange Commission 1997: 11-12). However, it is unlikely that this will make recognition truly independent of the market: "The single most important criterion is that the rating organisation is nationally recognised, which means the rating organisation is recognised in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings" (Securities and Exchange Commission 1997: 5). Since their information is treated confidentially, they are freer to express their opinions openly (Interview SEC, 13.12.1999). Thus the opinion of the market – and not of the regulatory agency – is decisive for SEC recognition.

The definition of 'NRSRO' is not the only means the SEC has used in attempting to establish some form of control over rating agencies. Mandatory registration of investment advisors is also planned under the Investment Advisory Act. The compensation that clients pay to investment advisors is strictly checked as is the information they are required to disclose to their clients. Investment advisors are subject to inspection by SEC personnel, who examine their records and their record keeping methods. Rating agencies already register as Investment Advisers on a voluntary basis, but they are granted special status exempting them from most provisions of the act. For fear of loosing this privilege, the biggest rating agencies staunchly oppose mandatory registration under the act (Molé 1998, O'Neill 1998, Baron 1998). This opposition is likely to be successful, since it is likely that the SEC will not have a mandate to regulate rating agencies under the Investment Advisory Act. The Supreme Court ruled that even impersonal investment advisers that publish investment letters are excluded from SEC review.

In sum, it is unlikely that the present reform will lead to real supervision in spite of calls to this effect from lawyers (Bottini 1993) and even investors (Tyle 1998). On the contrary, the SEC’s regulation has not only failed to establish an effective voice mechanism, it has also weakened competition in the rating market (Molé 1994). Requiring that firms use rating agencies that have its stamp of approval raises the barriers to market access for new rating agencies. It is becoming more difficult to overcome the threshold to respectability, because investors may not appeal to the new agencies to satisfy regulatory requirements. And because no investor uses the new agencies, they will not achieve NRSRO status. This is a regulatory catch 22.

Consequences of the accountability gap

The accountability gap arising from the unfettered mandatory enforcement of the rating agencies' standard of credit-worthiness leads to problematic consequences. The approach chosen here predicts that expertise-based standards discourages "voice" on the part of the users as a reaction to a decline in performance. This is certainly true for rating agencies. In times of normal operation, investors using credit ratings rarely dispute them. Financial analysts or portfolio managers working for investors are indeed sometimes dissatisfied with ratings. For example, in the aftermath of the Asian crisis, the agencies' ratings of the 'Asian Tigers' suffered a severe loss of credibility. However, they are more likely to ignore a rating they do not believe than to challenge rating agencies. The reason for this is that no institutionalised feed-back mechanism exists that could connect users and rating agencies. For example, there is no professional association of financial analysts which would serve as a permanent forum for a differentiated exchange of views between rating agencies and their various users (Interview Standard & Poor's 12.11.1999). The only option available to a dissatisfied investor is to call the responsible rating analyst to discuss a decision he or she believes to be wrong. Investors seem to be rather reluctant to do so (Interview American International Group 10.01.2000). Borrowers, the other group using ratings, will even have a harder time voicing complaints to rating agencies when they feel that their rating does not adequately reflect their credit-worthiness. Rating agencies will refuse to listen to them in order to avoid anything that could tarnish their image of neutrality. Furthermore, given the absence of effective supervision and the lenient liability regime, it is hardly surprising that borrowers and investors rarely challenge the rating agencies' work, even when they feel that the analysis was faulty. A weak voice mechanism does not necessarily mean that there is no incentive for correcting low institutional performance. Another highly effective mechanism associated with the market is 'exit', i.e. the refusal to buy the products of a firm. However, in the case of the rating agencies' standard of credit-worthiness, exit is not an option for users because the use of ratings is mandatory. Institutional investors such as pension funds cannot decide not to consider ratings for a while until they have become more reliable. They can only reduce the reliance on ratings for internal uses. At most one finds 'hidden exit'. Thus, unfettered mandatory enforcement deprives rating agencies of negative feed back and an external check on declining performance.

Strong negative feed back can only arise under exceptional circumstances. In times of a general crisis, communicating political risks can enhance the power of voice. This has been forcefully underlined in the recent debate on the future international financial architecture.

Several international financial institutions have analysed the role of rating agencies in financial markets and their share of the responsibility in the crisis (OECD, World Bank, IMF). A consensus seems to have emerged that the rating agencies on the whole have high professional standards and have performed no worse than the financial analyst community as a whole (Adams et al. 1999). However, they have not escaped unscathed. In times of crisis, changes of credit ratings seem to have a pro-cyclical effect on the dynamics of financial markets and thus aggravate rather than stabilise a crisis (Adams et al. 1999: 186). Furthermore, in times of crisis, control by reputation does not work either: rating agencies can intensify their mutual observations, thus producing similar ratings in order to avoid being the only one wrong (Economist, 13.12.1997, p. 87). Also, the use of ratings in regulation was called into question because of their low reliability in times when regulation is most necessary. Rating agencies have responded both by justifying their practices and publicly revising their rating methodology (Adams et al. 1999, p. 212; Interview Duff & Phelps, 10.11.1999). If the dynamics of exit and voice presented here is correct, then drawing lessons co-operatively, as was done after the Asian Crisis, is the exception, whereas quiet undisturbed operation is the rule. With their sense of the neutrality of expertise, as a rule rating agencies learn alone. The inferior adaptation capacity resulting from this is hardly likely to be adequate in a post-Fordist age characterised by a high rate of change (Piore/Sabel 1984).

In sum, neo-institutionalist organisation theory suggests that rating agencies have to be observed with a dose of scepticism because their standard-setting activities largely go unchecked. Thus, the reason to be critical is not because they engage in 'ideological uncertainty transformation' which provides legitimacy for organising the financial world in a way that favours the interests of a capitalist class. It is because rating agencies may not adapt their standard of credit-worthiness fast enough to avoid harm to borrowers and lenders. The risk of intermediation associated with the rating agencies makes it possible to appreciate the positive side of their activity. They enable transactions that otherwise would not be possible (and by so doing they may even have welfare enhancing effects). As such, they also merit a certain degree of protection. In the framework of the standardising approach the question following from the problematic aspects of rating agencies is: what possibilities are there for remedying the accountability gap? I shall specify this question of 'institutional design' in the conclusion.

Conclusion

This paper proposed to understand rating agencies as standard setters for credit-worthiness in international financial markets. This view is based on a specific concept of "standards" that highlights the normative character of the rating agencies' expertise for credit decision-making. I have argued that these standards are at the heart of a mode of governance that derives its peculiar characteristics from the fact that private non-binding rules are enforced by government regulation. Given the potential of such a governance mode to enhance the flexibility of regulation, it seems to be an important mode of governance. That makes it even more important to acknowledge its systematic weaknesses, here identified as a systematic deficit in accountability which risks sacrificing the flexibility of the credit-worthiness standard and thereby also jeopardising the intended increase in regulatory flexibility.

The analysis in this paper is based on the argument that insofar as the material criteria guiding the rating agencies are publicly available, they constitute a standard of credit-worthiness. However, this is not to deny any difference between more common forms of standard setting and credit standardising. Rather, the tension resulting from the comparison points to how this case could contribute to a theory of standardisation as a mode of governance. So far, enforcement has only been attributed to third-party enforcement by government regulation. However, this neglects the 'first-party enforcement' of the standard of credit-worthiness by the rating agencies themselves. The process of assigning a rating can be seen as verifying their standard of credit-worthiness. In this sense rating proper is similar to auditing, a form of control adapted to the increasing importance of self-regulation by the market (Power 1997). Thus, the case of credit rating raises the question: how could the theory of governance by standardisation profit from the concept of 'auditing'?

Another question for further research is the normative question of institutional design. The paper has pointed to a weakly developed control mechanism for rating agencies – either through state supervision or liability law. What leeway is there for improving mechanisms that hold rating agencies accountable? In answering this question it could be helpful to compare rating agencies with similar intermediary organisations such as accounting firms or to the situation of rating agencies in different countries. The result of such a comparison is that there may simply be little institutional malleability. A comparison with international accountancy firms reveals a difference that could explain the difficulty in developing better mechanisms for holding rating agencies accountable. Whereas the standard of credit-worthiness enforced by the rating agencies is drawn up by the very rating agencies themselves, in the field of accountancy these standards are set by independent national and international professional associations. This could be the reason why a well developed supervisory regime exists in the area of accountancy. These external standards are useful as a supervisory standard because they contain explicit operating rules for the auditing firms (Gaa 1988, 5-7). The rating agency's credit-worthiness standards do not contain explicit rules of behaviour for credit rating agencies; as the frequent emphasis on the qualitative nature of the rating agencies' work indicates, such rules are tacit knowledge and thus stored away in an organisational black box. For this reason, should there be stronger public supervision of rating agencies, the public supervisors will have to develop their own material rules; and this is an extremely challenging task. A cross-national comparison reveals the difficulty in constructing a liability regime for credit rating agencies. In Germany a semi-public agency can be called upon to check on the credit-worthiness of individuals and firms. Unlike the rating agencies, this agency is not exempt from liability. This may well be because, on request, the German credit information agency disseminates information on the past credit record of individuals and organisations, especially in cases of insolvency. Rating agencies' judgements do not refer to the past, but to the future likelihood of a default; and, on the basis of a past credit record, it is much easier to establish whether the information given was correct and if not, who is to blame. For risk assessments that refer to the future, however, this question is much more difficult to settle (at least according to German civil law; see Lemke 2000, 32-33). Of course, no exhaustive list of speculative remarks on theoretical and institutional issues has been offered here. Those issues discussed here have been presented to outline the type of questions that are raised for future research once credit rating agencies are conceived of as standard setters.

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