Growing Doubt about Moody's — JCIF Report

By Sakamoto Sakae

The International Monetary Fund (IMF), which failed to cope with the Asian financial and economic crisis, is under fire. Even George Soros, a noted hedge fund operator, who amassed a fortune from the globalization of U.S.-style economic and market systems (the so-called "global standard" in Japan), is propounding the theory that the IMF is incompetent. He is advocating that a "world central bank" be established.

And at a recent conference of international economic and currency experts, the hedge funds were criticized for throwing not only markets but also the economy into chaos, and steps to bridle its activities came up for discussion. Until only a few months ago, many people in the Japanese mass media had been critical of Malaysian Prime Minister Mohamad Mahathir for his alleged ignorance of the realities of the world market. Recently, however, there have been emerging moves to appreciate the farsightedness of Mahathir, who has been condemning hedge funds.

Oba Tomomitsu, the president of the Japan Center for International Finance

Even some U.S. scholars lash out at the globalization of U.S.-style economic and market systems as reflecting America's willful attitude of forcing the "Wall Street/Washington complex" on other countries. They charge the Clinton administration for its fusion with Wall Street and for compelling other nations to accept the values of U.S. banks and securities companies.

The mounting criticisms being leveled against two major U.S. rating agencies — Standard & Poor's and Moody's Investors Service — in Japan may well be taken as an extension of the doubts about such U.S.-style economic and market systems. In this column in the previous issue (article, titled "Japan's Downgrading Fans Criticism of U.S. Rating Agencies"), I introduced some of the voices ranged against Moody's. This time, as a follow-up, I reproduce part of a report compiled by the Japan Center for International Finance (JCIF, President Oba Tomomitsu, former Vice Minister of Finance) under the title "Characteristics and Appraisal of Major Rating Companies" (published in December 1998).

Unsolicited Rating and Three Questions

In the previous issue, I pointed to the "precariousness" of the income structure of rating agencies by writing, "The earnings structure of rating agencies, which may be called information service companies in a broad sense, is unique. This is because their main source of income is not subscription fees collected from information buyers (investors who need information for their investment decisions), but rating fees earned from companies planning to issue bonds (those companies are comparable to news sources for the mass media)."

Especially, I expressed doubt about their arbitrary behavior, saying, "Several years ago rating agencies began to rate credit standings of companies without their requests. The Moody's downgrading of Japan was such an 'unsolicited rating.' 'I suspect unsolicited ratings are part of the business tactics adopted by rating agencies to win requests for ratings,' says a top executive of a certain company. 'They may be considered a kind of intimidation,' he adds."

The JCIF report critically took up the unsolicited rating behavior (especially the way Moody's publishes ratings without distinguishing between unsolicited ratings and those on request), and asked three questions. First, refuting the rating agencies' assertion that it is their duty to rate companies on the basis of open information, whether requested to or not, it pointed out that "Rating agencies receive a greater portion of their revenue from clients. Investors and client companies are economic entities with conflicting interests, so relying on both leads to a clash of interests." Question 1 refers to the earnings structure of rating agencies.

Second, the report hits back at the rating agencies' contention that if there is a difference between ratings on request and unsolicited ratings, the responsibility rests with the company for not disclosing management information, and not with the rating agency. On this, says the JCIF, "In the case of unsolicited ratings, the agency does not meet executives of the target company. The quality and vision of managers provide an important element of judgment for ratings. In this sense, unsolicited ratings are inferior in 'quality' to ratings on request." This is tantamount to the omission of the most important process of news reporting by a news organization.

Many people support Malaysian Prime Minister Mahathir Mohamad's criticism of hedge funds

Third, the JCIF refers to the denial by rating agencies that they are using unsolicited ratings as a business tool to win firm orders for ratings and their claim that unsolicited ratings are being done fairly and objectively. It quotes market sources as saying "in no few instances have rating agencies sent invoices for commission to those companies subjected to unsolicited ratings." The JCIF stresses the need for fully monitoring whether rating agencies are engaged in "illegal business activities" by using their influence. As is clear in the top executives' remarks quoted in my previous article, this has become "common knowledge" among rated companies.

U.S. Corporate Culture Vs. Japanese/Asian Culture

The JCIF, touching on the limits to the rating business of rating agencies based on the U.S. corporate culture, further points out: (1) The U.S. rating companies predicated on the U.S. corporate culture tend to ignore Japanese corporate culture in rating Japanese enterprises, and (2) A look back at the financial crisis in Asia shows that rating actions by U.S. rating agencies have exacerbated the market turmoil in Asia where the rating culture is not rooted. At the beginning of this article, I wrote that there are moves to review U.S.-style economic and market systems. This view gives rise to doubts about rating as "a component" of the U.S.-style systems.

According to the JCIF report, a survey was conducted on the "aftermath" of the twenty five Japanese companies rated by Moody's five years ago as "speculative" (Ba or below). It shows that none of these Japanese companies had their long-term bonds defaulted. On the other hand, 11.4% of those U.S. companies rated by Moody's as Ba or below since 1970 had their bonds defaulted within five years after their flotation (more than 20% since 1990).

What can be said from such data is that Moody's is a fairly good judge of U.S. enterprises, but is not necessarily right when evaluating Japanese enterprises. There seems to be a limit to the capability of U.S. corporate culture-immersed rating agencies to grasp the managerial status of Japanese companies steeped in Japanese corporate culture. Judging from such a comparative study, the JCIF states, "It is possible that the structual low-default factor generated by Japan's peculiar corporate governance has been thought light of in Moody's ratings of Japanese corporations."

With regard to the relationship between the Asian financial crisis and U.S. rating agencies, the JCIF concludes, "As evidently seen in Indonesia and South Korea, U.S. rating agencies downgraded their sovereign nations (external credit standings) when the contagion of the economic crisis became considerably clear. Judging from this, they could not fully read the speed and depth with which the crisis was spreading." It thus points out that there was a limit to U.S. rating agencies' "eye to read not only Japan but also Asia." The JCIF notes that the series of downgrading actions taken by U.S. rating agencies against Asian countries generated resonance with market reactions, amplifying the Asian currency crisis. To put it another way, it says, U.S. rating agencies muscled into the Asian market and poured "oil" all over the "fire." JJTI

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