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Fitch, Moody's and Standard & Poor's Haven't Learned Enough from the Financial Crisis

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The Big Three credit-rating agencies came under a great deal of criticism in the wake of the 2007-08 implosion in mortgage-related securities and financial institutions in the United States, and also over their questionable judgments about European sovereigns and banks during the financial crisis which went on to unfold there.

These agencies – Fitch, Moody's and Standard & Poor's – stood accused of defrauding investors by offering overly favorable assessments in prior years, and also of exacerbating consequent financial turmoil. Governments in both the United States and Europe subsequently took steps to regulate the three main agencies, and to promote greater transparency and competition in the industry.

Now there is a growing risk that a deterioration in the creditworthiness of emerging-market countries in 2016 and beyond will leave the Big Three exposed to justified criticism once again.

The rating agencies have been generous with their creditworthiness assessments. In the past decade, they have given many countries credit for achievements that were the direct or indirect result of explosive growth in China and exceedingly loose monetary policies in Europe, Japan and the United States. It was the combination of these forces that created enormous bubbles in the commodities, stocks, bonds and currencies of most emerging-market countries–from Africa to Asia and Latin America.

Many countries were promoted during 2000-2007, and even during the transition years of 2009-2013, at least two of the Big Three firms awarded coveted investment-grade ratings to Colombia, Indonesia, Morocco and the Philippines, among others. Indeed, sovereign creditworthiness in emerging markets as measured by the Big Three has remained largely unchanged over the past five years, with the two notable exceptions being recent downgrades to Brazil and Russia–though the former is still investment-grade as per Fitch and Moody's, and the latter as per Fitch.

Long credit booms

And yet, the global financial tide went out five years ago, and to paraphrase Warren Buffett, the number of emerging-market swimmers exposed as naked has been growing all the time. The pace of economic growth in these countries has slowed down in 2015 for the fifth year in a row, their inflationary pressures remain unabated, and their fiscal and balance-of-payments performance has steadily weakened.

Many emerging markets have experienced long credit booms: The level of corporate debt in the emerging markets quadrupled between 2004 and 2014, as reckoned by the IMF in a recent report. Therefore, state-owned and private companies are highly vulnerable to the unfolding scenario of lower exports, domestic sales, and profits because their balance sheets have become more stretched and more susceptible to leaner market conditions.

Foreign-currency exposures have increased sharply, and the confluence of sizeable leverage with currency mismatches has increased the sensitivity of these economies to a tightening of global financial conditions. Many of the banks in the emerging markets have thinner capital cushions, and their nonperforming loans are rising as corporate earnings and asset quality deteriorate.

Market sentiment has turned “brutally and decisively against the emerging world” in recent years, as observed recently by John Authers of the *Financial Times*. Stock markets have steadily dropped further behind the developed world, access to the international bond market has diminished, and emerging-market currencies have depreciated sharply.

Contagion from emerging markets

According to a recent Fitch Ratings/Fixed Income Forum investor survey, institutional investors see contagion from the emerging markets as the top risk to the U.S. credit markets over the next year, and the securities of corporations in those markets were the least-favored asset class among respondents.

So what have the Big Three rating agencies done? Their assessments are supposed to be valid for the long term, and to withstand likely future business cycles. But as was the case with their evaluations of mortgage-related securities, financial institutions and sovereigns in the United States and Europe in the run-up to 2008, one wonders whether even what has already transpired was duly weighed four or eight years ago, when so many rating upgrades were decided.

Likewise, the agencies appear to be shutting their eyes to what the financial markets have been signaling–and for several years now–in the hope that investors will reverse themselves once the Federal Reserve actually implements its first rate hike. The impression is that the Big Three are betting that once the “big bad wolf” stops growling and claims its first victim, the world will be a safer place.

Exhibit A: Peru

The question can be elucidated further by focusing on a concrete case, and our Exhibit A involves the agencies' assessment of Peru's creditworthiness. The Big Three promoted Peru to investment-grade in 2008-09, and they subsequently upgraded it further to "A3" (Moody's) and "BBB+" (Fitch and Standard & Poor's), with similar or even higher ratings for the government's domestic debt.

None of these high Peru ratings have been slimmed down in recent years despite the fact that the country, a quintessential commodity exporter, has come under pressure as of late and the rating agencies' economic projections have repeatedly proven overoptimistic.

It bothers us, however, that none of the Big Three have made it plain to current investors that the government of Peru has long been in default on old bonds now owned by a mix of domestic and foreign investors. These are bonds which were originally issued when the country was ruled by a leftist military government in the 1970s, and one-third of total agricultural acreage was seized for the benefit of peasants, with bonds given to landowners in partial compensation for their losses.

And yet, the bonds are legal obligations which the highest courts in Peru have ordered the government to revalue (to adjust for past inflation and currency devaluation) and to start servicing. Doing so would not put much of a burden on the country's public finances, but the troubling aspect is the unwillingness to pay that successive governments in Peru have demonstrated. This is no minor matter when it comes to the proper credit evaluation of a sovereign.

In recent months, two small but independent rating agencies, HR Ratings and Egan-Jones, have done their own assessments of Peru, and both properly assigned a "D" rating to the defaulted land-reform bonds while the latter, after taking into consideration this default and other weaknesses in the underlying credit story, also rated Peru a mere "BB" credit.

Might the case of Peru be the proverbial canary in the Big Three rating agencies' mine?

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