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“Trust in the shadow banking system: ratings agencies and discursive power”

Trust – Sub Theme 2

Organisational Trust: Challenges and Dilemmas

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Trust in the shadow banking system: ratings agencies and discursive power

Introduction

“Like priests in the medieval church, ratings agencies representatives spoke the equivalent of financial Latin, which few in their investor congregation actually understood. Nevertheless, the congregation was comforted by the fact that the priests appeared to confer guidance and blessings. Such blessings, after all, made the whole system work: the AAA anointment enabled SIVs to raise funds, banks to extend loans, and investors to purchase complex instruments that paid great returns, all without anyone worrying too much...” (Tett, 2009; 118).

The purpose of this paper is to consider a less visible form of trust production which led to the global financial crisis of 2007-2009. In many ways, the financial crisis was the first to result from a breakdown of assurance mechanisms, or generators of trust (Yandle, 2008). In other words, this particular global crisis was, at its core, a crisis of trust. What is also unique, though less adequately discussed, is that the global financial crisis was initially triggered not by a loss of public trust, but by an internal loss of trust between actors within the financial system itself. I refer specifically to the breakdown of trust between visible financial system and the ‘shadow’ financial system, the latter representing a sizeable portion of the system that is largely invisible to the public eye. For the purpose of this paper, I define organisations as “sites where members subject themselves and one another to various practices, where discourse sustains mutually reinforcing patterns of power and powerlessness” (Conrad and Haynes, 2001; 65). Power resides in these discursive practices, including the organisational knowledge formation and claims about it. In his discussion of trust in trans-organisational relations, Bachmann (2001), looks at the complex social processes involved in inter-firm relationships, and finds that firms operating within national boundaries have a shared world of institutional arrangements which govern the forms of trust relevant when engaging in specific relationships with each other.

I argue here that in the modern financial system, acutely globalised and disembedded from national economies, different rules of trust production apply. It is my intention therefore to explore the trust structures which allowed a visible financial system – consisting of retail banks, insurers and other institutions – to co-exist with a far more complex shadow financial system of

special purpose vehicles, hedge funds and unregulated structures through power mechanisms created through discursive practices. In order to present these trust structures, I re-assemble the financial system as an organisation, sharing a dual trust structure, but with different underpinnings in the ‘visible’ and ‘shadow’ elements of the system. Whereas the visible financial system is backed by trust imbued by central banks and regulators within national boundaries, the shadow system was backed instead by trust produced discursively by global rating agencies.

Companies operating in today’s global markets are on an increased search for legitimacy, building trust among key stakeholders in order to reap increased profits. The task of building trust in financial systems is made more challenging now that financial markets are more interconnected than ever through technology and 24 hour media. Increasingly, people are doing business with people they never see, in transactions that take place instantly. Nowhere is this more apparent than in global debt capital markets, where it is credit ratings agencies that aim to close the ‘trust at a distance’ gap, which might otherwise hinder fundraising in debt capital markets. As world bond markets have increased in size, credit ratings agencies – notably Standard & Poor’s, Moody’s and Fitch – have operated as voluntary ‘trust guardians’ (Shapiro, 1987), charging fees to evaluate the risk of organisations which borrow money in capital markets, interpreting and assessing the credit worthiness of borrowers, assigning a credit rating to their debt instruments and publishing that credit rating for the entire market, so that there is transparency to borrowers and lenders alike.

Credit ratings are translated to investors through symbols, which represent the quality of debt issued. It is through these symbols that ratings agencies convert trust into a saleable product, automatically creating an active trust market (Zucker, 1986). The ratings scale was simple enough for both experts and laypeople to understand. If something was triple A it had minimal probability of default if it was triple B or triple C it had far more risk and was therefore less trustworthy. When a credit rating agency assigns a debt instrument an AAA rating, it is considered a ‘prime’ rating with virtually no chance of loan default. Such clear-cut designations were comforting to all market players (Tett, 2009). Since institutions tend to invest more in companies with high bond ratings (Bhojraj and Sengupta, 2001), the top bond rating issued by credit ratings agencies – AAA – is highly desirable. Ratings symbols separate out those companies that are trustworthy and those that are untrustworthy, making it simpler and easier for borrowers and lenders who have never met to do business with each other. Credit ratings

therefore came to act as mnemonics for trustworthiness in the form of credit quality; “put simply, “AAA-rated companies don’t default” (Partnoy, 1999; 635-636).

Although trust is considered crucial to success, there are few coherent concepts concerning how to deal with trust in business (Rottger and Voss, 2008). Ultimately, this study should extend other approaches to trust production by offering a critical approach, and a novel research design. I begin the paper with a short background on shadow banks and the unravelling of trust in the summer of 2007. With the shadow banking system in mind, I then theorise system trust drawing on the work of Giddens and Foucault. I draw on relevant literature to present a new model of trust, one that reads trust production as a series of discursive and material practices enacted by various actors. Finally, I propose a framework through which to understand how system trust in shadow banking was first produced then lost, backed by the discursive power of rating agencies. By examining trust in this way, trust production, as organised by institutions in the financial system, becomes more visible, more detailed and less nebulous than may have been considered to date.

System trust and shadow finance

Theorising system trust

The financial system is ‘the business of trust’, (Knights et al, 2001), and it is even more so in modern times when daily turnover on the world’s foreign exchange markets far exceeds the annual level of world exports (Held and McGrew, 2000). Trust has always been a central element wherever credit (lending) takes place (Kincaid, 2006). Credit is derived from the Latin for ‘to believe’ (Kincaid, 2006). But how did so many financial actors come to believe in and trust the shadow banking world? A growing body of literature has evolved around the idea that modernity has been accompanied by a qualitative shift in trust relations (Giddens, 1994). Giddens (1990) offers system trust as a solution to the modern condition of risk and danger because of trust’s ability to compress space and time. System trust is a faceless, impersonal form of trust which we, the public, place in money, and increasingly in expert systems such as finance. Giddens argues that people are able to trust large, abstract systems through a process of disembedding, in which social relations are lifted out of their local contexts of interaction and

restructured across indefinite spans of time-space (Giddens, 1990; 21). Expert systems – that is, the network of experts connecting across time and space within and between different fields – are disembedding mechanisms which provide us with ‘guarantees’ of expectations across distanced time-space. Trust is, in part, an article of faith, based upon the experience that such expert systems generally work. What counts in any given situation where two actors confront one another is an imbalance of skills or information. In the case of the financial system, there is a perpetual imbalance concerning the tradable value of a financial asset at a particular moment in space and time.

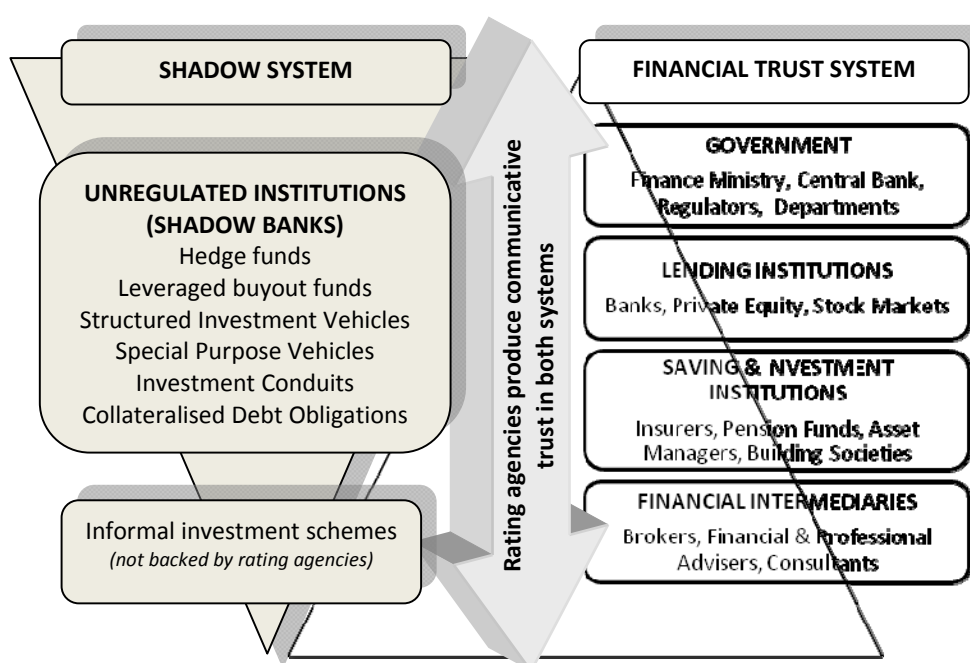
The other principal disembedding mechanism identified by Giddens is money. It is here that the unique link between finance and trust is truly forged. Money works to reduce complexity and manage expectations, when traditional symbols of trust and authority have given way to competence in risk management (Gilbert, 2005). Money needs constant ‘feedback’ but does not require specific built-in guarantees and is therefore incomparably easier to acquire than trust placed in strangers. Giddens emphasises that it is money as such which enjoys trust, rather than the individuals or organisations with whom particular transactions are carried out. Anyone who trusts in the stability of the *value* of money assumes that a system is functioning and places his trust in that function, not in people. This point becomes crucial in considering how trust ‘seized up’ within the global financial system.

Lapavistas contends that it is the state which regulates money and imbues it with trust, ultimately ‘lending’ trust to financial institutions (Lapavistas, 2006). These financial institutions have differing influence over money and the trust that goes with it, becoming layered in a ‘pyramid of power’ (Kincaid, 2006). The management of modern credit money draws on social power and trust invested in central banks (Lapavistas, 2006). National central banks sit at the apex of the financial trust pyramid (*Figure 1*), providing guarantees to money and sustaining the trustworthiness of banks and financial companies at lower levels. Kincaid (2006; 41) refers to this provision of guarantees as “a socialisation of trust, backed by the power of the national state”.

Because shadow banks sit outside of the regulatory system they also sit outside this formal mantle of trust. However, the power and influence of shadow banks was able to grow through system trust operating between financial institutions. Shadow banks were experts in opaque practices such as securitised lending through unregulated vehicles, knowledge that few in the

‘real’ banking system could fathom (Tett, 2009). Since few were certain of how to value complex financial instruments, they looked for an overt sign of trust that investing in the shadow banking system was ‘just as good’ as depositing money in a real bank (McCulley, 2009). At this point, credit rating agencies stepped in as specialists in trust production (Zucker, 1986). They produced market-derived rating symbols, devices supplied to reduce the cost of trust formation (Yandle, 2008).

Figure 1: (Adapted) Financial trust system with shadow system (Author)²



Theorising trust production

² The pyramid has been adapted from Costas Lapavitsas’s presentation of trust built socially through the credit system (See Lapavitsas, C. 2006), which he in turn adapted from the Unoist Marxist tradition. Lapavitsas describes the credit system as a pyramid-shaped, layered set of institutions, markets and assets. Lapavitsas’ focus was the flow of trust in wholesale capital markets, i.e. central banks, money markets, banks and trade credit. I have adapted the suggested original to include a range of mainstream financial institutions that cater to a lay audience, and have further included a ‘shadow pyramid’ of trust showing the dual position of rating agencies.


As the preceding discussion demonstrates, system trust allows us to interpret the processes that produce trust. However, it leaves opaque the precise and non-discursive practices employed by system actors in order to produce trust. Here, it is useful to draw on insights from Foucault's extensive body of work, primarily that concerned with power produced through discourse (Foucault, 1969, Foucault, 1976). Like Giddens, Foucault establishes a direct link between power and expertise, but Foucault makes expert systems the primary source of power, submitting that discursive strategies are forms of expert knowledge (Foucault, 1981). Foucault defined society by its multiplicity of fields of knowledge, highlighting the production of meanings, the strategies of power and the propagation of knowledge. Discourse is everything written/spoken about a specialist practice/knowledge, '*controlling*' those who lack specialist knowledge. Specialists produce statements about their practice, '*regimes of truth*' defined by the 'discursive rules' of their field (Faubion, 1994). In this way, the experts at rating agencies produced a discursive regime of truth about the trustworthiness of 'Triple A' rated credit instruments, despite the inclusion of less trustworthy 'subprime' mortgage debt within those instruments.

In order to fully understand how sales outfits such as rating agencies were able to simulate trust production for the shadow financial system in the way that the state did for the visible financial system, it is necessary to understand the wide range of trust practices that a credit rating agency is able to enact within financial systems. In order to consider the underlying practices involved in producing system trust in money and financial expertise (*Table 1*), I have proposed a model for trust production in financial systems guided by Foucault's notion of the knowledge/power apparatus, an idea later developed and given more detail by Jäger (2001).

Once the underlying practices which make up the financial system are uncovered and brought to light, it is possible to see that trust practices are linked with the materialisations of financial returns, as well as the discursive statements asserting value and performance records recording that financial return. Therefore, a banking institution (shadow or real) wishing to be trusted will engage in trust practices such as reporting their investment performance (discursive) and in expertly managing investments (non-discursive actions). If the institution goes on to produce financial returns, it will be trusted. If it does not produce financial returns, it will be mistrusted. But the crux of the matter with shadow banking was that its products were

new and complex, with no track record. So the meaning of ‘performance’ and ‘value’ was elusive, and could not be precisely located (Lanchester, 2008). Once those meanings were brought into question, no one was sure of the value of assets, and system trust unravelled.

Table 1: Financial Services Trust Practice Framework (Author)

TRUST PRACTICE FRAMEWORK			
1. Protecting	2. Guaranteeing	3. Aligning	4. Making visible
<i>“We represent our customers’ best interests since they bear the risk”</i>	<i>“We are certain of delivering set results in a set time frame”</i>	<i>“We associate with other trust codes and systems”</i>	<i>“We are truthful, thus transparent about how we do things”</i>
Building wealth or reducing debt Managing risk while providing customers with exit strategies Assigning high/low trust actors e.g. custodian to look after funds Respecting property e.g. installing and monitoring customer data protection Adopting an industry role as ‘consumer champion’	Keeping promises, honouring contracts, repaying money Producing certification of competence, expertise Monitoring system soundness Assessing effectiveness of policies Enlisting third party endorsement, recommendation, ratings, warranties, seals of approval	Adopting standards and codes of ‘best practice’ e.g. auditing Complying with law and regulation Foregoing competitive imitation Recognising and supporting customer loyalty Negotiating against stated expectations, with willingness to compromise Supporting socially responsible behaviour	Making and pricing accessible, transparent products and services Making transparent contract terms Measuring financial performance, reporting frequently, honestly Submitting or subscribing to monitoring and assessment Giving customers a voice, listening to and acting on complaints Apologising for failings (accepting vulnerability); making amends
			
<i>“We are expert enough to explain what we do in plain terms”</i>			
Seeking binary divisions, selecting and omitting messages, clarifying financial jargon, explaining and educating on technical occurrences in markets, ranking product providers, separating opinion from fact. <i>Discursive tools include:</i> websites, fact sheets, brochures, websites, press releases, speeches, commentary, case studies, targets, forecasts, statements, audits, surveys, ratings			

The Case Study: credit agencies and trust production

Over the past decade, debt capital markets became vastly more complex. At the turn of the century the ‘dot com’ boom collapsed. Regulators lowered the cost of borrowing to keep economies buoyant, and the credit market became the new game in town (Tett, 2009). New and highly-innovative financial instruments were introduced, and as they proliferated, eventually a dual system arose. Despite state emphasis on transparency, (Keegan, 2007; 8), experts in the visible financial system were setting up ‘wonderfully opaque’ financial vehicles in the shadow financial system, thus avoiding regulatory scrutiny. Hedge funds exploded on to the scene trading in various forms of creative financing (Tett, 2009). Highly-levered lending and investment institutions such as structured investment vehicles (SIVs), hedge funds, leveraged buyout funds, collateralised debt obligations (CDOs), investment conduits, specialist monoline insurers, and increasingly, levered mortgage and investment banks proliferated, creating a shadow financial system (McCulley, 2009).

The shadow financial system is primarily differentiated from the visible financial system because of its unregulated status. It does not enjoy the formal mechanisms that generate trust between the public and the visible financial system. ‘Trust at a distance’ becomes an even greater issue because these instruments were highly-innovative, therefore untested (Jones et al., 2009), highly-complex, therefore comprehensible only to specialists and largely unregulated, therefore invisible on company balance sheets. Credit ratings agencies played a significant role in the growth of this ‘invisible’ derivatives market by acting as the most visible, recognisable and formal trust mechanism for high-risk debt. Investors did not always understand the complex new instruments behind this creative financing, but complexity was vastly simplified by ratings assigned to these new instruments by ratings agencies. Credit ratings such as ‘AAA’ appeared unbiased and served to simplify complex financial instruments, giving them a veneer of transparency and standardisation. Ratings were backed up by massive research, which was a key element in the rating agencies’ sales pitch” (Tett, 2009). In a largely unregulated market, credit ratings ultimately served as a proxy for regulatory influence from the state. A Triple A ‘anointment’ from a credit agency enabled operators in the shadow financial system to raise funds, real banks to extend loans to them, and investors to purchase complex instruments that paid great returns with minimum worry (Tett, 2009).

The visible and shadow financial systems became heavily interconnected, an entire system organised around mutual trust with the purpose of reaping profit. In record time, financial innovation became the fastest-growing segment of the rating agencies' business. Much of that business includes transactions *designed* to capture particular ratings (Partnoy, 1999). The increased availability of prime-rated instruments in the shadow banking system attracted investors from all over. Shadow financial entities and visible financial institutions intermingled, yet shadow entities were rarely acknowledged or reported on by the mainstream (Tett, 2009).

The lack of external scrutiny meant that, over time, the global credit rating system was able to institutionalise several problems and weaknesses. Firstly, rating agencies were paid by investment banks that issued debt instruments in the first place. In this biased system, agencies had incentives to give higher ratings to more instruments in order to earn higher fees from volume (Yandle, 2008). Secondly, the ratings agencies' method of valuing complex financial instruments was so opaque and difficult to fathom, that few were in a position to contest the assigned ratings. Tett (2009; 111) likens ratings agencies to "priests in the medieval church", speaking the "equivalent of financial Latin, which few in their investor congregation actually understood". Thirdly, global three rating agencies were effectively a 'government-mandated' cartel (Yandle, 2008; 352), with many countries promoting regulatory recognition of rating agencies (Mutti, 2004). Finally, while the shadow system did have the benefit of a state-produced safety net as was the case in the visible financial system, each system was becoming heavily invested in the other, steadily becoming intertwined with Triple A debt instruments offering the portal from one world to another.

The shadow financial system increased visibility very suddenly in June 2007, when two highly-levered Bear Stearns hedge funds collapsed, initiating the breakdown of subprime-backed collateralised debt obligations (CDOs) (Brown et al., 2008). As the summer of 2007 wore on, panic in the credit markets intensified. Banks lost trust in hedge funds, demanding they begin posting more collateral for loans. Many hedge funds could not comply. Along with other investors, they began dumping any assets that might contain default risk, causing asset prices to fall. This made banks even more nervous, and they began hoarding cash. The cost of borrowing rose until the interbank lending market effectively collapsed as real banks became reluctant to lend to each other (Yandle, 2008). As Tett (2009; 217) explains, banks either "needed that cash, or did not trust each other – or both". An entire network of 'shadow banks' suddenly discovered

that its lifeblood had been cut off (Tett, 2009). Ratings no longer reflected competitive market forces (Yandle, 2008). Consequently, in October, Moody's cut its rating on billions of medium-risk mortgage-backed bonds, warning that it might also downgrade billions more which carried the Triple A rating. A few days later, Standard and Poor's put a slew of CDOs under review, followed hot on its heels by Fitch. An entire structured credit edifice had been built on the assumption that Triple A was ultra-safe. Now the term 'AAA' had now lost its discursive meaning. The cut in credit ratings acted a 'trust solvent' (Yandle, 2008; 343), causing trust in the shadow financial system to evaporate into thin air.

In order to offer some critical reflection on trust production as a mechanism in debt capital markets, I have chosen Standard & Poor's, one of the world's largest rating agencies as a site where members of the debt markets subject themselves and one another to various practices. I will explore selected excerpts from the discourses deployed by Standard & Poor's between 2005 and 2007 when the global financial crisis erupted. My aim is to apply the trust practice framework in a discursive analysis of these selected texts in order to develop a closer understanding of trust production as a process in complex financial systems. I am specifically interested in understanding which trust practices ratings agencies deploy and which they do not; how these practices relate to the mass production of mistrust that occurred in the global financial system in the summer of 2007, and finally, what patterns of power and powerlessness emerged in respect of ratings agencies and other discursive actors named within discourses of Triple A credit worthiness.

The Empirical Study: discourse analysis, methodology and method

Discourse analysis

Jäger (2001) provides a terminology and methodology for discourse analysis. Whereas other qualitative methodologies might explore themes, Jäger identifies 'discourse strands'. These themes or discourse strands operate on various 'discursive planes', which are fields of activity such as the sciences, politics, media, education, everyday life, business life or administration. Discourse strands are themselves comprised of 'discourse fragments' or texts. Jäger prefers the term discourse fragment to 'text' since texts can address several themes and thus contain several discourse fragments. A text can contain various discourse fragments which emerge in an

entangled form, which he refers to as a ‘discursive entanglement’. Jäger describes a discursive event as one that is emphasised politically, generally by the media. Discursive events influence the direction and quality of the discourse strand to which they belong to a greater or less extent. The identification of discursive events is also important for the analysis of discourse strands, because sketching them marks out the contours of the discursive context to which a current discourse strand relates. Finally, a ‘discourse position’ refers to a specific ideological location of a person or a medium. These discourse positions can only be revealed as the result of discourse analyses.

Jäger sets out five steps for conducting discourse analysis. The first step entails a brief characterisation of the sector and of the discourse plane. The second step involves establishing and processing the material base or archive. The third step in Jäger’s approach to discourse analysis involves structure analysis, which is evaluating processed material vis à vis the discourse strand. The next step involves a fine analysis of one or several articles or discourse fragments, typical of the sector under exploration. The final step in Jäger’s approach is an overall analysis of the sector concerned. Jäger does not propose slavish adherence to his five steps as variations are always possible. However, he suggests paying keen attention to dealing with the discourse analysis of the discourse strand at issue, of the sector concerned, on a discourse plane. He also points out that every discourse strand has a history, a present and a future. Thus, a through approach to research would involve analysing longer time frames of discursive processes in order to reveal their strength, the density of the entanglement of the respective discourse strands with others, changes, the fractures, drying up and re-emergence (Jäger, 2001). I have applied Jäger’s steps in analysing select documents relating to Moody’s and Standard & Poor’s between [specified years], leading up to the global financial crisis.

Establishing and processing Standard & Poor’s material

Standard & Poor’s is a US-based, global ratings agency. Frequently known as ‘S&P’, the firm celebrated its 50th anniversary in 2007, though its history dates back more than 150 years. Standard & Poor’s is also widely known for maintaining one of the most widely followed indices of large-cap American stocks: the S&P 500 (Standard & Poor’s, 2011). In 2009, S&P published more than 870,000 new and revised credits ratings. Currently, the company claims to rate more

than US\$32 trillion in outstanding debt (Standard & Poor's, 2011). Ratings agency analysts are paid relatively modest salaries, have limited upward mobility and may be responsible for tracking the credit quality of scores of companies. Yet they are generally paid significantly less than equity analysts and large agencies such as S&P tend to have high levels of staff turnover (Partnoy, 1999).

Generally, when S&P is asked to rate a new instrument, representatives of the issuer meet with the agency's analysts and disclose the facts they believe are relevant. Ideally, the analyst then has a few weeks to apply the relevant statistical model, and submit a report to an internal rating committee, which will meet to vote on the appropriate rating, Triple A or otherwise. In the case of the sophisticated instruments in the derivatives market, S&P and its competitors have developed proprietary systems and models for analysing these complex structures. In the case of the Commercial Mortgage Backed Securities (CMBS) market, for example, S&P has its own criteria for rating securitisations backed by commercial mortgages. The agency begins with the underlying real estate, since it is important to ascertain the property's income-producing capability for the life of the rated transaction (Standard & Poor's, 2004). After being engaged to rate a transaction, Standard & Poor's analysts will typically visit a representative sample of properties, meet with management, analyse historical and current financial statements, and review all third-party reports.

The modeling assumptions developed by S&P and other ratings agencies are generally published in documents that are made available to borrowers and lenders, and there is a fair degree of transparency in that many of these documents are available on the company's website. The models are scrutinised by analysts in the markets, and S&P and its peers will periodically revise these models to reflect newly-available data or application of new statistical theory. While the models may be based on mathematical equations, the final credit rating is still subject to the opinion of a committee, hence the products produced by S&P in the form of ratings are based on opinion, and as with many financial models, they attempt to project future probability based on data from past financial events.

Fine analysis of selected texts

Despite the significant agency power held by firms such as Standard & Poor's, it was impossible for the public and for regulators to ignore the fact that Standard & Poor's together with its main competitor, had given Enron, the energy company, a good rating just four days before it collapsed in one of the largest bankruptcies in US history (Mutti, 2004). While regulatory scrutiny of rating agencies increased after Enron, leading to new legislation, Standard & Poor's worked assiduously to represent the agency's work as public information rather than commercial advice. To this end, Standard and Poor's lawyers published a memorandum establishing legal as well as constitutional arguments for S&P's deliberate positioning as a 'financial publisher'. The memo is excerpted below:

July 2005

Standard & Poor's Memorandum

The First Amendment Protections Afforded to Rating Agencies

"In a wide array of circumstances, state and federal courts have consistently recognized that S&P and other rating agencies are entitled to the same First Amendment protections as other financial publishers such as *Business Week* and *The Wall Street Journal*.

These decisions have been based on widespread judicial recognition that, at their core, rating agencies perform First Amendment functions by gathering information, analysing it and disseminating opinions about it — in the form of credit ratings and commentary — to the general public... All of S&P's published rating actions are also made available to the public for free on its Web site, along with thousands of articles of fixed income-related commentary.

...Courts have consistently extended the protections of the First Amendment to S&P and other rating agencies. Most recently, the judge overseeing the multidistrict Enron litigation recognized that S&P's credit ratings deserve the "constitutional breathing space" afforded by the First Amendment because they are "opinions" about important public issues distributed "to the world."

...In recognizing these full First Amendment protections, courts have concluded that rating agencies are fundamentally different from other market participants, such as public accountants, who do not enjoy the same First Amendment protections..."(Poor's, 2005).

Two interesting aspects of trust and power emerge in the reading of this text. First of all, Standard & Poor's appears to argue that its role in debt capital markets is less powerful and less influential than subsequent events show it to be. Secondly, and perhaps more interestingly, is the fact that the company has chosen to weave in an important American narrative, invoking its right to freedom of speech as enshrined in the US constitution.

The second discursive strand selected is a news article carried by Bloomberg News, the financial publisher, replicating a ratings action deployed by Standard & Poor's in October 2006. The ratings action concerns Bear Stearns, the investment bank which eventually spiraled into trouble the following year. The discursive strand is selected to demonstrate S&P's positive view on the company less than a year before its subsequent downgrade:

27 October 2006, Bloomberg News

'Merrill Lynch, Goldman, Bear Stearns Ratings Boosted (Update3)'

"Merrill Lynch & Co., Goldman Sachs Group Inc. and Bear Stearns Cos., three of the five biggest U.S. securities firms, had their long-term credit ratings raised by Standard & Poor's Corp. on improved risk management...Bear Stearns advanced to A+, one below its bigger rivals.

...The rating changes will help reduce the companies' cost of borrowing as they use debt to boost trading with the firms' own money... "Risk management at these firms has improved substantially," [Brad] Hintz [of Bernstein Co] said. "Still, are they taking on too much risk by relying on such unorthodox capital?"

[James] Keegan [of American Century Investments] said he was "substantially" underweight the sectors, meaning that he held less than half the amount of brokerage bonds than are in investor indexes.

"We don't see a lot of upside," he said in an interview. "The ratings companies, by their nature, tend to validate what the market already knows."

...S&P said...Bear Stearns's upgrade reflects "relatively low profit volatility, conservative management and cost flexibility"... (Bloomberg, 2006).

In many ways, 2006 was a banner year for rating agencies. There was unprecedented issuance of CDOs and other complex instruments. There was plenty of supposedly healthy Triple A debt about, and a hungry market, eager to gobble it up. Yet what is significant about this second discursive strand 'upgrading' Bear Stearns is the seed of doubt planted by the two analysts who are also quoted by the Bloomberg journalists. The first analyst acknowledges that firms such as Bear Stearns have improved their risk management processes, yet, when he refers to 'unorthodox capital', he is concerned that the bank may be over-exposed to the wrong kind of risk. The second analyst states that he is 'underweight' on companies such as Bear Stearns compared to his peers in the investment industry. He makes it clear that he sees no reason to increase his holding in the near future because S&P has effectively provided 'stale news'. Meanwhile, 2006 was a particularly busy year for S&P as it was just one of the ratings agencies

to revise certain models used to evaluate high-risk instruments such as CDOs (Nomura, 2006). It had become patently clear that their models failed to accurately predict the performance of securities tied to risky mortgages (US Senate, 2011). Significantly, S&P – together with its peers – did not immediately incorporate their revised models into credit ratings for a wide-range of derivative products. Instead of sending an early signal to the market in July 2006 of the deepening problems with high risk mortgages and securities tied to them, the agencies waited until July of 2007, to begin a series of mass downgrades (US Senate, 2011). The next excerpt comes from Reuters newswire, describing the latest set of downgrades as events move toward crisis mode:

13 July 2007

Reuters

CDO drama may spark bargain hunt after fire sales

“...As pension funds and insurers prepare to possibly sell billions of dollars in bonds tied to dicey mortgages after ratings agencies downgraded them, Wall Street looks ready to buy what Main Street investors may cast off.

"We are hoping for that moment when the baby gets thrown out with the bath water," said Mitch Stapley, chief fixed-income officer for Fifth Third Asset Management, which has \$12.7 billion invested in debt.

...Before the buying is likely to begin, investors of all stripes said prices need to fall more. Already this week, the benchmark ABX indexes, used by investors to hedge subprime mortgage risks, slumped to record lows while spreads on more liquid junk bonds widened, but not by the same magnitude.

"We've already seen them drop 50 cents on the dollar and if they lose their ratings, a lot of pension funds are going to have to blow that paper out. And that will be ugly," said John Mauldin, a hedge fund investor at Millennium Wave Advisors.

It's also an event that could reverberate through global financial markets, unleashing a wave of selling of a wide array of riskier assets from stocks to corporate bonds.

...Mohamed El-Erian, the president and chief executive officer of Harvard Management Co., the world's largest educational endowment fund, said, "The big question now is whether the recent move by rating agencies to downgrade several instruments will result in forced sales by rating-constrained investors who had sought to benefit from the rating arbitrage," (Reuters, 2007).

The sudden shock of those downgrades contributed to the collapse of the secondary markets for subprime residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs), left investors holding suddenly unmarketable securities, and helped precipitate the financial crisis. However, the ‘last straw’ for many investors was the loss of confidence in Bear Stearns, the global investment bank, which already suffered the collapse of its

two highly-levered Bear Stearns hedge funds collapsed (CDOs) (Brown et al., 2008). Standard & Poor's ratings actions on Bear Stearns served only to feed the panic, illustrated by the next excerpt:

**3 August 2007, Bloomberg Business Week
'Standard & Poor's Ratings Direct'**

"Aug. 3, Standard & Poor's Ratings Services said it revised its outlook on Bear Stearns (BSC) to negative from stable. Standard & Poor's also said that it affirmed its A+/A-1 issuer credit rating on Bear Stearns as well as its ratings on various Bear Stearns affiliates.

Notwithstanding the challenges Bear Stearns currently faces, S&P believes the company's liquidity is strong. "Still, the negative outlook reflects our concerns about recent developments and their potential to hurt Bear Stearns' performance for an extended period," notes S&P credit analyst Diane Hinton. "We believe Bear Stearns' reputation has suffered from the widely publicized problems of its managed hedge funds, leaving the company a potential target of litigation from investors who have suffered substantial losses."

"...The ratings could be lowered if large losses were to be incurred over the next few quarters or if earnings failed to stabilize at a satisfactory level beyond the next few quarters, which we expect will be—at best—difficult ones for the company. On the other hand, if Bear Stearns can overcome current challenges and effect a more rapid recovery than we currently anticipate, the rating outlook could be revised back to stable"(Bloomberg, 2007).

On first reading, the story appears to carry good news and bad news – while S&P's has downgraded Bear Stearns, it maintains that the bank's liquidity is 'strong'. However, the intertextuality of this particular discursive strand is important. As the next excerpt from AP Dow Jones news wires shows, the market saw only the negative and Bear Stearns was, all too soon, to face its demise:

**6 August 2007
Dow Jones
'S&P says market overreacting to Bear Stearns outlook change'**

"...The stock market overreacted after Standard & Poor's lowered its long-term outlook on Bear Stearns Cos.' credit ratings to negative Aug. 3, an S&P managing director said Monday.

Shares of Bear Stearns fell by as much as \$8.60 Monday... after losing more than \$7 on Friday, and are off about a third so far this year. The company failed to staunch the selloff despite holding a conference call Friday to defend its funding and earnings strength and firing one of its top executives over the weekend.

"We think it's all overplayed," said Scott Sprinzen, an analyst at S&P's financial institutions rating group on Monday afternoon. "Our thinking in making the change was pretty modest in comparison to the wholesale readjustment the market seems to be making."

...Sprinzen said S&P adjusted its outlook negatively only on Bear Stearns because of the collapse of two subprime mortgage-dominated hedge funds and problems at a third fund..."(Dow Jones, 2007).

Attempts by Standard & Poor's to play down the effect of its earlier downgrade, only underscore the power of a rating agency's 'freedom of speech', enshrined in the US constitution. A simple discursive shift from 'stable' to 'negative' deployed widespread mistrust in Bear Stearns and helped to spell the bank's demise.

Discussion

The Standard & Poor's discursive thread covering selected strands from 2005 to 2007 help to uncover some of the practices of ratings agencies. In my view, these excerpts suggest ratings agencies in most trust practices hypothesised in the trust framework in Table 1. Most certainly, rating agencies engage in the act of *guaranteeing*. By publishing extensive analyses of company financial data and producing a rating from D through Triple A, rating agencies offer to 'populate the future', as impossible as this may be (Giddens, 1990). However, while rating agencies promote their Triple A guarantees, they are unwilling to accept commercial responsibility for what they say, which renders their 'guarantee' incomplete. When it comes to the act of *making transparent*, rating agencies are murkier still. On the one hand, agencies claim to publish information regarding the models they use to arrive at their decisions; yet their research and their ratings do not match. Standard & Poor's hung on to revised models developed in 2006, failing to apply them until 2007, with unfortunate consequences.

Rating agencies most certainly engage in the act of *aligning*: they receive regulatory backing in many countries which are active in debt capital markets. Rating agencies serve a vital, voluntary role in deregulated markets, where countries seek to avoid excessive regulation. In addition, rating agencies work closely with the world's most powerful investment banks – among the best-known names in global finance. However, while this may produce trust in the activities of rating agencies, it has been pointed out elsewhere that in the measurement of investment risk investors are the one group that rating agencies ought to be aligned with, and indeed *protecting*, and yet this is the one group that agencies continually let down.

The trust practice that rating agencies seem to perform most ably is the act of simplifying. Borrowers and lenders lean heavily of rating agencies to clarify and simplify the increasingly sophisticated and complex world of high-tech financial instruments. Not only do

market players seek clarity, they seem it quickly. Until the summer of 2007, the term ‘Triple A’ told the actors in both the visible and shadow financial systems everything they needed to know. It is these simple mnemonics ‘AAA’, ‘BBB’, ‘CCC’, that have delivered substantial power to rating agencies, a power backed by the state, which has encoded ‘Triple A’ into its requirements for investment and pension funds all over the world. And yet, curiously, the trust practice that the state has not enshrined is that rating agencies should engage, first and foremost, in the most powerful trust practice of all – *protecting* investors.

Conclusion

Ratings agencies operated in both the real and shadow banking system, creating an active market for trust. However, ratings agencies primarily operate at the discursive end of the trust practice framework guaranteeing, aligning, making visible and simplifying. Ratings agencies provide third party endorsement by guaranteeing a company’s ability to pay its debt. They align the market by issuing credit rating standards. They make financial institutions more visible by publishing research on company performance. Above all, ratings agencies translate and simplify the meaning of complex financial instruments by offering symbols that investors can easily identify. Rating agencies are merely third party intermediaries. The trust practices they engage in are varied, but their agency power is primarily discursive. They do not engage in the most powerful financial trust practice of all, that of protecting and safeguarding deposits of money. This is an important lesson to understand when assigning future trust roles in complex financial systems.

This has been a preliminary study into the discursive and material practices of actors within the financial system. Discourse analysis is a highly subjective methodology and the selection of discursive strands and the decision to edit and excerpt them will reflect some degree of bias, which can be addressed, in part, by an increasing number of researchers bringing their different subjectivities to the theme chosen here. Nor do I claim that my observations of the flaws in the credit rating system are new. However, from an organisational perspective, I believe the trust practice framework provides a useful mechanism for applying and measuring an organisation’s ability to produce both trust and mistrust, equipping researchers and

practitioners to uncover, recognise and address systemic flaws particular during times of significant shift, as has happened in debt capital markets since 2000.

From an organisational perspective, the trust practice framework also highlights that the production of mistrust can also be a deliberate strategy within organisations and systems. In the case of debt capital markets, just as a Triple A rating produces trust, a negative ratings action such as the downgrade to Bear Stearns on 3 August 2007, deploys mistrust. Mistrust may be as necessary to the human condition as trust is, but its repercussions can be powerful and deleterious. If we hand over mistrust production to any player in our organisation or system, then we must acknowledge the nature of the power we hand over to these actors, and ensure that there are checks and balances to their power.

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