A new report has highlighted room for improvement in Australian credit ratings agencies, including potential conflicts of interest, overseas staff producing credit ratings, and failures to meet compliance standards.

Having effective credit ratings agencies is vital for Australia, as they assess the creditworthiness of governments, corporations, banks and other entities that wish to raise funds by issuing debt.

The agencies' decisions can have knock-on effects throughout the economy. The ability of governments to borrow money has an impact on investors and companies, and companies pass on the cost of borrowing to their customers.

Read more: ***Why we should be wary of ratings agencies***

Ratings agencies are trying to represent not only the ability of borrowers to repay their loans, but also the willingness to repay on time.

Ratings are given as a ranking. AAA is the highest, then AA and A, right through to C and then D (default).

The lower your credit rating the riskier you are deemed to be and the higher the interest rates charged. Some institutional investors (such as pension funds) are not allowed to hold debt with a credit rating of BB or below.

The exact methodology used by the ratings agencies is not publicly released. But ratings are based on a mix of public information and private information provided by the debt issuers.

When it comes to giving the federal government a rating, agencies will use publicly available economic data such as economic growth, income per capita and unemployment and inflation rates. This gives the agency an idea of the current state of the economy, as well as where it might be in the short and long term.

Agencies will also look at the federal government's budget. They will consider the gap between revenues and expenditures, when the government's debts are due, and the quality of assets that the government could sell off.

Lastly, the agency will look at the wider economic and political context. This includes the quality of financial regulators and levels of corruption and political stability. It also includes potential internal or external vulnerabilities, such as an economic slowdown in China or the possibility of a trade war.

All of these factors have an impact on the ability and willingness to repay debt, even if they are beyond the government's control.

Similar considerations are applied to the credit ratings of banks and other large corporations. But the agency would also consider how likely it is that the government would bail out the company in a crisis. There is a perception , for example, that the government would bail out the big four banks.

The impact of credit ratings

Last year S&P put Australia on a " negative outlook ", meaning the federal government's AAA credit rating could be downgraded.

The immediate impact of a credit rating downgrade is that the interest rates paid by the federal government will go up. But research shows that a federal government ratings downgrade has wide-ranging impacts.

The credit ratings of both banks and many corporations are tied to the federal government's.

This means a federal government downgrade will have impacts on many companies, investors and individual borrowers.

Share markets would be affected, but so would other borrowers, including foreign governments.

Further, the credit assessments of governments and banks are often intertwined, especially in times of financial crises.

Read more: ***Australia could be about to lose its AAA rating, and here's why***

The link between governments and banks can create a negative feedback loop. A downgrade for either banks or governments increases bank borrowing costs. This makes it more likely banks will need to be bailed out by the government in the near future. This puts more pressure on the government's finances, which could lead to another government credit rating downgrade.

But a downgrade doesn't affect only banks. Recent research shows that when a government's credit rating is downgraded, companies with similar credit ratings also see a ratings change, even if there is no fundamental change in their own creditworthiness.

Again, there is a negative feedback loop. A government credit rating downgrade leads to downgrades for corporations. The corporations, faced with increased borrowing costs, will respond by cutting back on new investments, which slows down the real economy. The slowdown in the economy will put more pressure on the government's credit rating.

And on top of all that, when banks face higher borrowing costs, they either pass this on to households and investors in the form of higher lending rates and/or cut back on their lending.

This, of course, also has the effect of slowing down the economy, creating a double whammy.

So you can see that ratings agencies play an important role in the economy.

The Australian Securities and Investment Commission has made a number of recommendations to improve governance within credit ratings agencies, to make them more informative and reliable. Adopting these will go a long way to further restore market confidence in the ratings agencies and improve investor protection.

Eliza Wu receives funding from the Australian Research Council.

Authors: Eliza Wu, Associate Professor in Finance, University of Sydney

Read more http://theconversation.com/explainer-what-are-credit-ratings-and-why-do-they-matter-79336