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Misguided Ventures: A Quasi-Public European Union Credit Rating Agency

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As speculative attacks against Member States persist, the European Union (EU) desperately is attempting to allay fears concerning the disintegration of Economic and Monetary Union (EMU). Much of the firepower for this onslaught is provided by these very financial intermediaries charged with assessing and communicating the health of euro area economies; namely credit rating agencies (CRAs). Thus, in 2008, the European Commission proposed a series of oversight initiatives which would centralise CRA supervision at the EU level. Endorsed by the High Level Group on Financial Supervision,[1] chaired by Jacques de Larosière, Regulation (EC) No 1060/2009 (CRA Regulation v1) came into effect on 7 December 2010. Shortly thereafter, the corresponding amendment (EU) No 513/2011 (CRA Regulation v2) was deemed necessary in order to compensate for outstanding issues.

Already, however, there are serious questions about whether these new multilateral measures are sufficient enough to prevent Europe from being held hostage by the procyclical behaviour of a cabal of private firms: Moody's Investors Services, Standard & Poor's (S&P) and Fitch Ratings. In fact, the European Securities and Markets Authority (ESMA) is busy designing the third regulatory framework to supplement these existing CRA regulations. It is due to be announced at the beginning of 2012. But will it be too late to salvage the current configuration of EMU or even be effective in redressing some of the most egregious elements of ratings? Extreme volatility now threatens the eurozone's largest economies; including France. Not even the United States is immune. In this attempt to correct some of the numerous offences with which EU officials have charged the CRAs, the European Commission published its 5 November 2010 consultation paper on credit rating agencies.[2] To reduce an overreliance on external ratings, inject

[1] European Securities Markets Experts Group, *Role of Credit Rating Agencies* (Brussels, 6 June 2008).
[2] Commission of the European Communities, *Public Consultation on Credit Rating Agencies,* (Brussels, 5 November 2010, IP/10/1471).

competition into the ratings space and enhance the transparency of the entire process, a structural solution is being entertained in the form of an EU credit rating agency. But is this the right approach?

Cause for grave concern among EU official is well warranted. Whether it was their haste in downgrading sovereign debt during the 1998 Asian crisis, their inability to foresee the collapse of fraudulent corporate giants like Enron (2001) and Parmalat (2003), or their assignment of high investment grade ratings to dubious subprime mortgage-backed securities, which contributed to the 2008 credit crisis, credit ratings agencies have been implicated in some of the most severe and destabilising financial and fiscal crises of the last two decades. Procyclicality is observed as negative downgrades hinder debt financing, dampen economic growth and thus precipitate further decreases. Irrespective of the ensuing political outrage and promises to correct such abuses, ratings agencies have managed to elude any serious regulation.

Now as the integrity of the monetary union itself is undermined, it is tempting to believe that the (re)politicisation of this largely depoliticised field of finance will have the desired countercyclical effects and restore stability to beleaguered Member States and financial markets. Yet can a quasi-public EU CRA actually correct some of these imbalances and inconsistencies evident in the ratings space or simply exacerbate them? This paper contends that this is a misguided approach that can only infuse more uncertainty about the quality of ratings, heighten the dependence on external forms of assessment, and undermine the EU's authority to manage effectively the sovereign debt crisis. Arguably, the current regulatory framework is inadequate as it fails to address principal problems, such as a fallacious analytics of ratings. But an EU credit rating agency can only entrench such distortions and amplify destabilising 'cliff effects' as it cedes further sovereign authority to market forces.

Sovereign Ratings

Sovereign rating ranges rest on a judgement – codified and commercialised as the 'risk of default' – about 'the capacity and willingness' of governments to raise the necessary resources for the timely servicing of their debt obligations.[3] Probability of payment must be concomitant with the tolerability of the costs of austerity/adjustment. Yet as the 'pain' threshold which a constituency can endure fluctuates according to its changing political economy, it escapes prescient quantification as a probability distribution through the utilitarian calculus of risk. Politics is just

[3] Moody's Investor Services, *Moody's Rating Methodology: Sovereign Bond Rating* (New York: Moody's Investor Services, 2008), 4.

too fluid and uncertain to be captured statistically; even in an ordinal range. Sovereigns rarely default in the way that corporates fail. Nevertheless, in their attempt to make the qualitative more quantitative, the 'opinions' that Moody's or S&P issues about this governmental capacity seem to be widely accepted. Coming to terms with this analytics of ratings and properly regulating it is pivotal to an effective EU policy response. Thus far, the EU has been reluctant to regulate the flawed analytics underpinning ratings themselves, which leaves Europe susceptible to further destabilising forces.

Overreliance on External Ratings

In part, the scope and authority of ratings derives from their 'certification' role. Institutionalised in regulatory capital requirements, certification is intended to identify whose ratings are appropriate for regulatory purposes in the EU. In order to be eligible as collateral for money market operations, securities typically must have an investment-grade for central banks to accept them. Financial contracts and the by-laws of corporations have similar suitability criteria. The European Central Bank's (ECB) 'credit quality threshold' is defined in terms of BBB+/Baa1 in its harmonised rating scale. Of course, as the recent cases of Ireland and Greece demonstrate, minimum credit rating thresholds can be suspended. Now the ECB will accept Greek defaulted bonds as collateral. Given Greece's tremendous medium-term solvency challenges coupled with Germany's move to recapitalise its own banks exposed to Greek debt, its default is imminent.

What is very odd, however, is that rather than removing references or reliance upon ratings, the ESMA registration process merely serves to enhance their status and the legitimacy of rating agencies. Lessons should have been learned from the 'Nationally Recognized Statistical Rating Organizations' (NRSRO) designation in the United States; of which there are ten. Only recently has the Rating Agency Reform Act of 2006 introduced criteria detailing what the NRSRO designation actually entails. Prior to 2006, however, certification by the Securities and Exchange Commission (SEC) was quite informal, which actually erected barriers to entry and solidified the duopoly enjoyed by Moody's and S&P. Ostensibly, this can repeat itself in the European context or dilute the lower-tiers of the ratings industry with a slew of relatively 'insignificant' rating agencies; the EU CRA amongst them. Such players are no match against goliaths the likes of Moody's or S&P who, in 2011, rated 112 and 126 sovereigns, respectively. Even Kroll Bond Rating Agency (KBRA) – at 59 sovereign ratings – is not considered as a potential challenger to these global full-spectrum rating agencies. Most new entrants simply appear resolved at carving out niche specialisations.

Beginning in 2009 with the Financial Reform Act (Subtitle C of Title IX), however, the US initiated a campaign to eliminate references to NRSRO ratings in certain statutes. The 2010 Dodd-Frank Act (Section 6009) continued this expungement. Reducing the mechanistic reliance on CRA ratings is also advocated by the Financial Stability Board (FSB).[4] Yes, alternative provisions first have to be identified and implemented. But an EU CRA and ESMA registration can have the opposite effect and institutionalise the significance of external ratings rather than remove them. At that stage, viable alternatives would be even more difficult to devise and operationalise. Even if the EU decided to expel Moody's or S&P, what prevents them from issuing ratings from their headquarters in New York?

By officially sanctioning the current practice, without correcting the fallacious analytics of ratings, I argue that the EU enhances the legitimacy of external, exogenous forms of assessment. Ratings, *per se,* are not problematic. Although ratings address the problem of asymmetric information between issuers of debt and investors, their informational value and marginal utility is minimal given that much of this knowledge already has been priced into market expectations. More sophisticated investors (e.g. PIMCO, Paulson & Co.) perform their own internal risk assessments and don't rely on Moody's or S&P to help them understand and evaluate creditworthiness. Arguably, a primary appeal of ratings is as an inexpensive form of outsourced due diligence. Failure, however, to conduct proper internal risk assessments often precipitates a crisis. External ratings may represent value of simplicity but accuracy suffers.

Given the uncertainty in calculating the risk of sovereign default, investors attempt to minimise such costs while searching for potential arbitrage opportunities. Irrespective of their actual quality, as regulatory licenses, ratings provide the chance for investors to capitalise on the creditworthiness differentials of Member States. Disparate governments become synchronically connected and comparable as ratings entitle them to varying degrees of accessibility to liquid capital markets. In other words, speculators now have the instruments with which to exploit the relative vulnerability of individual governments. Would these market participants even listen to an EU sponsored agency making claims about the health of its distressed masters? One cannot help but be incredulous of such assertions.

Reputational Capital

Without doubt, the constitution of authoritative knowledge relies on credibility. Given the tremendous intersubjective barriers to entry, market share in the ratings space is not easily gained;

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[4] Financial Stability Board, *Principles for Reducing Reliance on CRA Ratings* (Basel: FSB, 2010).

hence the present hegemony of the Big Two and a Half – Fitch is a distant third. In 2009, Moody's, S&P and Fitch issued an astonishing 97 per cent of all outstanding ratings across all categories. An EU CRA would need to convince these market participants – essentially the entire ratings market – to abandon Moody's or S&P and pay it to assess their creditworthiness. A solid reputation for impartiality and competence would be essential for its success. Here the EU's patronage can diminish any credibility which this quasi-public agency seeks to establish. Thus, an EU CRA must possess a substantial degree of independence. Of course, that is easier said than done.

Moody's and S&P's authoritative ascendance dates back to the rise of market surveillance mechanisms in the mid-nineteenth century. Henry V. Poor's was one of the first to systematically document the growing American industrial complex with the 1860 publication, *History of the Railroads and Canals of the United States of America.* Industrial statistics occupied John Moody's 1900 *Manual of Industrial and Miscellaneous Securities*, which included information about the stocks and bonds of financial firms and government institutions. Unfortunately, an EU CRA would not have the luxury of such a grace period. With the arrival of new CRAs, whatever minimal market share exists will further diminish, thus forcing many smaller firms out of the industry all together while elevating the status of Moody's and S&P.

The current sovereign debt crisis only complicates this credibility dilemma. Although at first adamantly opposed by the European Central Bank, after their 21 July 2011 Euro Area Summit, EU politician finally admitted what financial markets had long suspected: Greece has little alternative but to restructure its debt obligations. Reiterating their previous warnings, the main credit rating agencies announced that Greece's failure to meet its interest or principal payments in a timely fashion or on 'less favourable terms' constitutes 'selective' default.[5] Moody's confirmed that 'the probability of a distressed exchange, and hence a default, on Greek government bonds is virtually 100%'.[6] On the one hand, if the real objective of an EU CRA would be to lessen the burden on beleaguered Member States then it would be a farce. By no means is an EU CRA a viable solution to the chronic uncompetitiveness and fiscal profligacy that plagues the periphery economies of EMU. On the other hand, if this agency were to possess all the capacities and independence of a Moody's or S&P then it would be exactly like them.

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[5] Standard & Poor's, *When Would A "Reprofiling" Of Sovereign Debt Constitute A Default?* (New York: Standard & Poor's, 2011).

[6] Moody's Investor Services, *Moody's Downgrades Greece to Ca from Caa1, Developing Outlook* (New York: Moody's Investor Services, 2011).

Why would it behave in any other way? Again, both approaches would simply compound the difficulties facing the EU in managing effectively its sovereign debt crisis.

Conflicts of Interest

Discussions of potential conflicts of interest often focus on the remunerations models employed by rating agencies. As profit-maximising entities, CRAs earn the vast majority of their revenue from the fees that they charge issuers of debt. But this was not always the case. Prior to the creation of the NRSRO designation in the 1970s, subscription fees were the norm. Today, however, about 90 per cent of CRA income is derived from user fees. McGraw-Hill Financial, the parent company of S&P Ratings, generated a revenue stream of US$2.9 billion in 2010; while rating in excess of US$32 trillion in outstanding debt. With reported revenue of US$2.03 billion in 2010, Moody's Corporation was also quite profitable. Its first quarter revenue for 2011 jumped 21 per cent to US$577.1 million. Both Moody's and S&P have similar fees. S&P charges issuers of corporate debt up to 4.25 basis points for most transactions; with a minimum fee of US$70 000. Sovereigns can pay anywhere from US$60 000 to US$100 000. Although ancillary practices, such as consulting, contributed to their business, stipulations in the EU regulatory framework prohibit CRAs from providing advisory services.

Revenue dependence on user fees has been suggested as a potential source of conflict of interest. Grade inflation may attract more clients and, thus greater profits as issuers have an incentive to 'shop around' as they solicit the most favourable assessment. Such concerns may be warranted in regards to smaller CRAs. Moody's and S&P, however, are so well entrenched and command such tremendous market share that they are virtually immune from such pressures. Moreover, given the fragility of credibility, rating agencies have a vested interest in preserving and enhancing their reputation for impartiality. Although an EU CRA may not be primarily motivated by the bottom-line, grade inflation is a tempting low cost and highly effective strategy to entice new clients away from its well established competitors. Of course, in its nascent stages of trial and error, it is completely reasonable to expect a degree of overzealousness and inconsistency. Whether issuers would tolerate this volatility given the available alternatives is doubtful.

In addition to the 'user-pays' model, in its 2010 consultation paper, the Commission identified other possible options to stimulate competition between CRAs. The 'subscriber/ investor-pays' model would require institutional investors to obtain their own rating before they can buy a financial instrument. Issuers of debt would select the rating agency of their choice. The ambition is the creation of a 'subscriber-pays' rating market. However, the 'issuer-pays'

approach was a response to the 'free-riding problem' of nonsubscribers accessing published ratings. In today's information society, the confidentiality upon which the 'subscriber-pays' model rests would be impossible. Furthermore, the unsolicited ratings which this standard promotes can be deployed in a coercive fashion in order to increase a rating's circulation. Moody's conflict with the German reinsurer Hannover Rückversicherung AG is indicative of this dark side to unsolicited ratings. What would prevent an EU CRA from engaging in such tactics in order to drum up business? As it stands, the EU remains ambiguous about which business model, if any, it should endorse.

As troubling as the above issues are, where a conflict of interest is most blatant is in having an EU-sponsored rating agency assess the creditworthiness of its sovereign masters. Rating one's own debt is laughable. It is doubtful whether Brussels is actually concerned with how well Moody's or S&P appraise the economic health of a country such as Pakistan or Chile. The Commission is witnessing the disintegration of the eurozone and it wants a countercyclical safeguard to protect its ailing economies from any future onslaught. Whether there is actual merit to this position is really irrelevant. Market optics would portray a quasi-public EU CRA as a puppet of the national governments with which it is affiliated. This would destroy its credibility and tarnish the reputation of the Member States.

Two-Tier Rating System

Few would dispute that increased competition in the ratings space would be positive. Granting ratings agencies access to the information of issuers which do not employ them may promote independent ratings. But even the ECB questions if an EU CRA would enhance competition or simply erect artificial barriers to entry to the detriment of private rivals.[7] Taking into consideration the arguments outlined above, it is difficult to imagine how a quasi-public EU rating agency can accumulate the necessary reputational capital to compete with the likes of Moody's or S&P. If their oligopoly can be disturbed, then it will not be instantaneous. In fact, as I contend, an EU CRA may have the adverse effect of further cementing their dominance. This would create a two-tier rating system where the EU CRA plays a peripheral role relative to Moody's or S&P. To level the playing field and compel market participants to adopt the new agency's ratings, market distorting mechanism would be necessary. Otherwise, this asymmetry would undermine the position of the new EU CRA as a reputable alternative.

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[7] European Central Bank, *European Commission's Public Consultation on Credit Rating Agencies – Eurosystem Reply (*Frankfurt: ECB, 2011).

Preoccupation with the quantity of ratings, however, distracts attention away from the real problem: their dubious quality. Rating agencies have a dismal record of predicting the deterioration of economic positions. Only in less than 25 per cent of cases have Moody's and S&P cut a sovereign rating before the onset of a correction. Most downgrades occur once a crisis has already begun. Risk calculus divorces ratings from the messy and uncertain world of fiscal politics. It imposes an artificial budgetary normality onto the European political economy, thereby attempting to eliminate the alterity that exists between Member States.

Heterogeneous economies, however, cannot be reduced to probabilistic estimation of risk default. Uncertainty cannot be calculated and (mis)represented as a risk. CRAs claim not to design ratings as a probabilistically quantifiable frequency denoting the credit event of default or expected loss, but rather ordinal rankings of credit risk. Nevertheless, key (qualitative) political determinants, such as the stability and legitimacy of political institutions or the transparency of policy decisions, are framed in absolute risk terms in order to be tractable to the rational choice scenarios and stress tests implicit in CRA propriety models. Without any clear alternative to measuring creditworthiness, an EU CRA is bound to adopt this fallacious analytics of ratings. Thus, the end result will be even more suspect external assessments that threaten to cause even more instability and undermine EU efforts in managing its sovereign debt woes.

Conclusion

There is no simple method to regulate and sanction informal judgement. Although additional measures are necessary to compensate for the inadequacies of the existing CRA framework, I posit that a quasi-public EU rating agency is not the solution. Rather than reducing the mechanistic overreliance on external forms of assessment, an EU CRA can have the effect of actually heightening this dependence. ESMA registration can contribute to institutionalising the status of ratings while it dilutes the lower rungs of the ratings industry. That can only enhance the legitimacy of Moody's or S&P. Severe conflicts of interest will compound these challenges. Neither does this proposal redress the fallacious analytics of ratings and their poor quality. Overall, an EU CRA can undermine the EU's authority to manage effectively the sovereign debt crisis.