



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT **A**

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Rating Agencies - Role and Influence of their Sovereign Credit Risk Assessment in the Euro Area

Monetary Dialogue
December 2011

COMPILATION OF NOTES



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Rating Agencies - Role and Influence of their Sovereign Credit Risk Assessment in the Euro Area

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Abstract

Credit ratings have a huge impact on the access to and costs of funding, regardless whether the rated entity is a private enterprise or a sovereign borrower. Since the beginning of the financial crisis there has been a vivid and controversial debate about methods, timing and procedures used by these agencies.

In this compilation of five notes provided by members of the Monetary Expert Panel the role of the rating agencies and their influence on the euro area is discussed in more detail.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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INTRODUCTION

Credit ratings have a huge impact on the access to and costs of funding, regardless whether the rated entity is a private enterprise or a sovereign borrower. Recent market disruptions in the sovereign debt markets, e.g. the 19 October 2011 downgrading of Spain's sovereign debt, showed again the pivotal role of these agencies and the dependence of the financial markets on their judgement. Downgrading of sovereigns, or even the announcement of a possible future downgrade may jeopardise the achievements of implemented austerity measures at once. Even the establishment of the amended EFSF is influenced by rating agencies, which on several occasions hinted, that the rating of participating states may depend on the amount of guarantees they provide.

Since the beginning of the financial crisis there has been a vivid and controversial debate about methods, timing and procedures used by these agencies. The market power and the obstacles to new rating agencies entering the market have been widely criticised. Regardless of the new supervisory powers of the European Securities and Markets Authority (ESMA) on rating agencies this debate continuous.

The 'Report on credit rating agencies: future perspectives (2010/2302(INI))' adopted in March 2011 by the ECON Committee of the European Parliament addresses several topics on a macro- and micro-level such as over-reliance, competition in the rating sector, a European Credit Rating Foundation and sovereign debt rating. It also asks the Commission to assess alternative instruments in order to measure credit risk.

The proposal of the Commission ('CRAIII') is due by mid-November 2011.

- What are the positions of the ECB on the influence of rating agencies in the euro area?
- How could over-reliance on external credit ratings be reduced?¹
- What would be the costs and benefits of establishing a European rating foundation?² What would be the alternative proposals?
- Could the ECB or another institution (which might be already in the business of judging fiscal sustainability) take the role of an independent provider of sovereign credit ratings?

Five experts from the Monetary Expert Panel elaborated on these questions in more detail.

¹ See also Paragraph 1-9 in the above mentioned INI Report.

² See also the chapter on 'European Credit Rating Foundation' in the above mentioned INI Report (Paragraph 16-20).

ABSTRACTS

Sylvester C.W. EIJFFINGER - 1. Rating Agencies - Role and Influence of their Sovereign Credit Risk Assessment in the Euro Area

Rating agencies are lagging behind markets in their judgment, as follows from the subprime crisis and from analyzing the current sovereign debt crisis. Furthermore, their business model is flawed as they face major conflicts of interest and are very opaque in their methodologies. Also, the oligopolistic structure of the ratings market provides the three large Credit Rating Agencies (CRAs) with a very strong position, while new entrants have the greatest difficulty to enter this market.

We must reduce the reliance on these bad ratings, by attaching less importance to them in prudential regulation and accounting standards. Furthermore, more competition is needed to increase the quality of ratings. To facilitate this competition, the interpretation of ratings and to improve investors' own analyses, more transparency is also needed.

Finally, several policy options to change the ratings industry have been put forward, including a network of small agencies, a European Rating Agency, or even the delegation of sovereign rating to the ECB. The first option is least preferred, because of the entry costs, coordination problems and the lack of economies of scale. The delegation of sovereign rating to the ECB would in principle be possible, but not preferable as it leads to a conflict of interest within the ECB. That leaves only the option of a European Rating Agency as a way to improve rating quality and transparency. However, it also requires high investment costs and time for reputation building.

Guillermo DE LA DEHESA - 2. Euro Area Sovereign Debt Crisis and Rating Agencies

Ratings are a public good, and should therefore be improved, enhanced and globalized. The best solution for the intrinsic problems of Credit Rating Agencies (CRAs) is a correct regulation and supervision. Both should be based on harmonized global standards. In this process the US and Europe should take the lead. A level playing field would help to develop a larger market and creates incentives for more entrants in the present oligopolistic market and could therefore lead ultimately to more competition.

Anne SIBERT - 3. Ratings Agencies

In this note the extent of the alleged problems in the credit ratings industry is assessed and solutions are suggested. The viewpoint of the ECB is noted and it is considered whether it or a new partially publicly funded entity could provide sovereign credit ratings.

Nicolas VÉRON and Guntram B. WOLFF - 4. Rating Agencies and Sovereign Credit Risk Assessment

Credit rating agencies (CRAs) have not consistently met the expectations placed on them by investors and policymakers. It is difficult, however, to improve the quality of ratings through regulatory initiatives. In the short term, changes to the CRAs's regulatory environment, in a context of high market uncertainty, may add to market stress. The role of credit ratings in regulation should be reduced but eliminating it entirely would have significant downsides, at least in the short term. The transfer of ratings responsibility to public authorities, including the European Central Bank, is unlikely to be a good alternative because of inherent conflicts of interest. The notion of risk-free sovereign bonds is challenged by the crisis, but the most straightforward way to address this challenge in the euro area context would be the establishment of a euro-area-wide sovereign bond instrument.

Karl WHELAN - 5. Ratings Agency Reform: Shooting the Messengers?

The European Commission has produced a wide-ranging package of proposals aimed at reforming the way credit ratings are issued and used. The Commission's concerns about "hard wiring" of credit ratings into the operation of the financial system are well-founded but there are limits and pitfalls to the alternatives that they propose. The proposals on sovereign debt are largely unobjectionable but the idea that ESMA needs to approve credit risk methodologies is worrying in light of the wholly unreasonable criticisms of sovereign downgrades from elite European policy makers. Proposals to increase competition via issuers rotating their ratings providers are unlikely to do much to improve the quality of ratings unless the current issuer-pays model is changed. A more radical reform, involving a move towards an investor-pays model, needs to be considered.

NOTES - Rating Agencies -Role and Influence of their Sovereign Credit Risk Assessment in the Euro Area



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Abstract

Rating agencies are lagging behind markets in their judgment, as follows from the subprime crisis and from analyzing the current sovereign debt crisis. Furthermore, their business model is flawed as they face major conflicts of interest and are very opaque in their methodologies. Also, the oligopolistic structure of the ratings market provides the three large Credit Rating Agencies (CRAs) with a very strong position, while new entrants have the greatest difficulty to enter this market.

We must reduce the reliance on these bad ratings, by attaching less importance to them in prudential regulation and accounting standards. Furthermore, more competition is needed to increase the quality of ratings. To facilitate this competition, the interpretation of ratings and to improve investors' own analyses, more transparency is also needed.

Finally, several policy options to change the ratings industry have been put forward, including a network of small agencies, a European Rating Agency, or even the delegation of sovereign rating to the ECB. The first option is least preferred, because of the entry costs, coordination problems and the lack of economies of scale. The delegation of sovereign rating to the ECB would in principle be possible, but not preferable as it leads to a conflict of interest within the ECB. That leaves only the option of a European Rating Agency as a way to improve rating quality and transparency. However, it also requires high investment costs and time for reputation building.

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INTRODUCTION

'Credit ratings have a huge impact on the access to and costs of funding, regardless whether the rated entity is a private enterprise or a sovereign borrower. Recent market disruptions in the sovereign debt markets, e.g. the 19 October 2011 downgrading of Spain's sovereign debt, showed again the pivotal role of credit rating agencies and the dependence of the financial markets on their judgment. Downgrading of sovereigns or even the announcement of a possible future downgrade may jeopardize the achievements of implemented austerity measures at once. Even the establishment of the amended EFSF is influenced by rating agencies, which on several occasions hinted, that the rating of participating states may depend on the amount of guarantees they provide.'

Since the beginning of the financial crisis there has been a vivid and controversial debate about methods, timing and procedures used by these agencies. [Both] the market power of the CRAs and the obstacles to new rating agencies entering the market have been widely criticized. Regardless of the new supervisory powers of the European Securities and Markets Authority (ESMA) on rating agencies this debate continues.

The 'Report on credit rating agencies: future perspectives (2010/2302(INI))' adopted in March 2011 by the ECON Committee of the European Parliament addresses several topics on a macro- and micro-level such as over-reliance, competition in the rating sector, a European Credit Rating Foundation and sovereign debt rating. It also asks the Commission to assess alternative instruments in order to measure credit risk.¹

These developments raise several questions regarding the role of credit rating agencies and their regulation in Europe:

- How have rating agencies behaved and performed in the run-up to the sovereign debt crisis?
- *'What are the positions of the ECB on the influence of rating agencies in the euro area?*
- *How could over-reliance on external credit ratings be reduced?*
- *What would be the costs and benefits of establishing a European rating foundation? What would be the alternative proposals?*
- *Could the ECB or another institution (which might be already in the business of judging fiscal sustainability) take the role of an independent provider of sovereign credit ratings?²*

In what follows, these questions will be answered. First, we will review the recent literature, theoretical as well as empirical, to characterize the academic discussion of ratings. Then, we will compare the actions of rating agencies to the market opinion. Subsequently, we will draw some policy recommendations from the previous sections. Finally, the last section concludes.

¹ Topic description provided by the European Parliament

² Topic description provided by the European Parliament.

1. LITERATURE

After the subprime crisis the literature on credit rating agencies (CRAs) has grown tremendously in size. Many authors consider critically the role CRAs have played in the run-up to this crisis, and find that there are many flaws in the current model of external credit assessment and the use of the CRAs' judgments in accounting and regulation.

De Haan and Amtenbrink (2011) provide a critical overview of the debate on CRAs, the accompanying literature and the proposed regulatory measures at the European level. The authors first review the functioning of CRAs, and highlight the most important issues regarding the CRA business model. To start with, CRAs have an enormous influence on interest rates of bonds, sovereign as well as corporate. This is especially harmful when a rating action downgrades a bond to below investment grade, as this may trigger liquidation in the form of herd behavior by investors. Furthermore, regulatory requirements rely very heavily on credit rating agencies. This excessive reliance on rating agencies has been confirmed by, among others, Pagano and Volpin (2010) and White (2010) who states that "[e]ssentially, the creditworthiness judgments of these third-party raters had attained the force of law." This overreliance has also contributed to the subprime debacle. Additionally, De Haan and Amtenbrink (2011) state that central banks rely on CRA judgment for setting collateral requirements on lending.

Another severe problem with the CRA business model is the "issuer pays" construction, which can lead to conflicts of interest (as in the subprime market) and causes issuers to go "rating shopping", thereby selecting the CRA that provides the most favorable rating. Although reputational effects should mitigate this behavior by punishing rating agencies that provide too generous ratings, this effect has scarcely been observed (Mathis et al, 2009). This can be explained by another deficiency of the CRA market: the lack of competition. This is one of the main points of recent EU regulation (CRAIII), to which we will come back later.

Specific to the sovereign debt market, the CRA model also suffers from shortcomings. One is the lack of transparency in rating sovereign bonds. The three big agencies very often disagree about the rating of sovereign debt, which may follow from the fact that they all use different indicators. Although several empirical studies have tried to identify the weights that CRAs attach to the various indicators, this has provided no unambiguous results as of yet.³ The main determinants turn out to be GDP per capita, GDP growth, debt history, government debt and external debt. However, the weights are not easily inferred, so replication of the CRAs' decision process is not easy. Further complications arise from the observations that rating changes concerning one country also affect spreads of other countries, CRAs interact in a nonlinear way and that CRAs try to smooth their rating changes. The last effect, although the policy is aimed at stabilizing ratings, can lead to so-called cliff effects: while the rating does not change often, a change is likely to push the bond below investment grade, leading to severe liquidation effects.

We can apply most abovementioned general problems also to the market for structured products (another very important domain of rating agencies). A problem that was more severe here than for other markets is that of the "issuer pays" model: issuers could influence the terms of their rating, and structured their subprime bonds in such a way that they just obtained an AAA rating. This so-called rating inflation, together with the coarseness of ratings (i.e. the discreteness of the rating categories) and the excessive reliance of regulation on these ratings has been an important cause of the subprime crisis⁴.

³ See also Hill et al (2009) and Alfonso, Gomes and Rother (2011)

⁴ See Pagano and Volpin (2010).

A problem related to this, and to the smoothing behavior of CRAs, is the sluggishness of rating changes: during the subprime crisis, CRAs were very late in recognizing the losses from subprime instruments⁵. In the current sovereign debt crisis we also see this effect, as will be documented in the next section. Recent empirical literature has found support for this lagging behavior of CRAs. Reinhart (2002) already found that the agencies are notoriously bad at predicting currency crisis (which is what the current crisis would have been without EMU) although they do predict default very well after a currency crisis has occurred. This suggests that rating agencies should also consider other vulnerability indicators next to those related to default. More recently, Afonso, Furceri and Gomes (2011) have investigated the financial market's reactions to sovereign rating announcements. They find that markets react mainly to negative announcements (for both rating actions and outlook communication), and that these communications are not anticipated in the 2 months beforehand. This suggests that markets do not incorporate the same information in their analyses as CRAs, and that the CRAs' procedures are not transparent. This is confirmed by Gärtner et al (2011), who divide ratings into a systematic component, predicted by previously observed procedures, and an arbitrary component that cannot be explained. They find that both components affect credit spreads, but the arbitrary part becomes much larger during the recent crisis.

In an attempt to alleviate the problems with credit ratings, the European Commission has instated Regulation 1060/2009. De Haan and Amtenbrink (2011) describe the main thrust and shortcomings of this regulation. The main idea of the regulation is that there should be a legal basis and an enforcement mechanism that can decrease reliance on ratings, improve their trustworthiness (through registration and transparency) and simplify the supervision of CRAs. However, the certification of rating agencies may actually increase the reliance on their judgment, as it creates the impression that their ratings can be trusted. Furthermore, increased oversight can lead to the supervisor being responsible for the ratings, which goes against the principle of private ratings. These problems will not contribute to the increase of due diligence by investors, at least not when capital and other requirements still rely on external ratings.

To conclude this literature section, let us focus a very recent report by Intereconomics (2011), which has published a Forum collection of articles on credit rating agencies. The main question in this Forum is whether CRAs are part of the solution or part of the problem in the sovereign debt crisis. In this collection, several authors take into account the most recent state of affairs in Europe, including new regulatory proposals. In the first piece of this collection, Günther Tichy argues that CRAs follow the market rather than lead it. This caused an overreaction to the sovereign debt crisis, as is also shown in the next section. Furthermore, CRAs did not devote enough attention to real problems; instead, they focused on financial indicators. The underlying institutional reason is that CRAs received too much regulatory power. This holds especially for ECB collateral requirements, since these are largely based on ratings by external CRAs instead of the central bank's own assessments.

Karel Lannoo follows up on this by stating that the EU, like the US, should eliminate the regulatory reliance on external credit ratings. Additionally, he argues that the increased registration requirements for CRAs restrict entry, and that CRAs should be made more accountable by exposing them to civil liability.

Owain ap Gwilym and Rasha Alsakka analyze whether recent critiques on CRAs have a sound basis, by assessing their methodologies and the resulting actions. They conclude that the agencies' practices of providing watch and outlook signals have provided a lot of information to the market, as around 90% of the rating actions during the sovereign debt crisis has been preceded by such a signal. However, they still agree that governments and investors should attach less weight to the CRAs' judgments and consider a broader range of indicators. Moreover, they criticize a few proposed regulatory measures, such as

⁵ See White (2010).

suspension of ratings during financial assistance, the setup of a European CRA and increasing the advance warning period for sovereign ratings.

Donato Masciandaro focuses on the effect that CRAs have on yield volatility, and concludes that there may be excessive volatility related to the regulatory and licensing features of credit ratings. This has to be evaluated empirically to reach a more solid conclusion. He concludes by proposing two ways to get rid of this excessive volatility: disposing of regulation that is dependent on ratings, and improving the communication policy of CRAs to increase their accountability.

Finally, Bartholomew Paudyn focuses on the question whether a quasi-public EU CRA is a good idea. He concludes that this increases the dependence of regulation and accounting standards on external ratings, as it may form an additional entry barrier for new private agencies. Together with the ESMA registration requirement this creates more instead of less reliance on external ratings, while doing nothing to improve the fallacious analytics of ratings and their poor quality.

Below, we will delve deeper into one aspect highlighted by many authors: CRAs may lag behind the market in determining credit ratings.

2. COMPARING RATINGS TO SPREADS

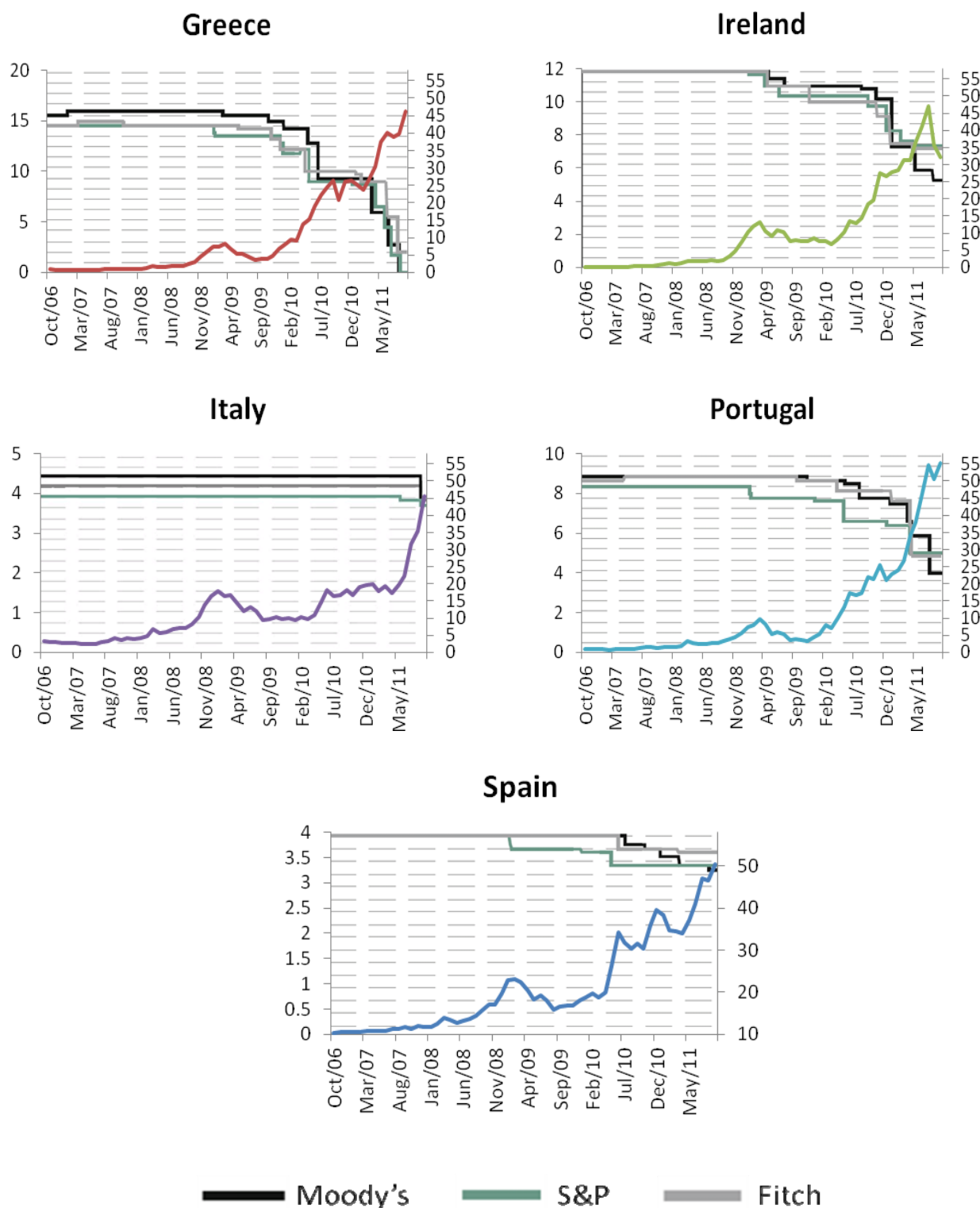
As mentioned above, in the Intereconomics Forum ap Gwilym and Alsakka analyze the lagging behavior of CRAs. They are less pessimistic than most authors, as a part of the lagging problem is alleviated by outlook and watch statements. They employ a method of transforming rating actions, outlook and watch statements into numerical values. Their scale consists of 58 points, incorporating the rating, outlook and watch status, as follows: Aaa/AAA = 58, Aa1/AA+ = 55, Aa2/AA = 52, ... , Caa3/CCC- = 4, Ca/CC, C/SD-D = 1, adding "+2" for positive watch, "+1" for positive outlook, "-1" for negative outlook, "-2" for negative watch, and "0" for stable outlook and no watch/outlook assignments. The data employed are from S&P, Moody's Investor Service and Fitch Ratings, running from October 2006 to August 2011.

To these ratings figures, we add the 10 year government bond spreads for the key players in the sovereign debt crisis: Greece, Ireland, Italy, Portugal and Spain. The spreads are calculated relative to the German bund, and are denominated in percentages.

The results of this exercise are plotted in figure 1 below, where the left axis indicates the bond spread and the right axis the rating score. A striking observation derived from this figure is that the positive attitude of ap Gwilym and Alsakka can hardly be justified, particularly when we consider the last 2 years. For most countries, the rating agencies lagged very much behind in adjusting their ratings, outlook or watch status. Concerning Ireland and Portugal, the agencies were quite up-to-date and also agreed on their rating downgrades. For Greece, Spain and especially Italy, however, they were significantly lagging behind the market's increase in yield spread. We can also see that S&P is the leading and most pessimistic agency, as it downgrades before the others do, and to a lower level. At the end of 2011, however, the ratings of most agencies converge, and even overshoot. This is especially severe for Greece and Ireland, who experienced very sharp downgrades to excessively low levels.

Together with the observations from the literature this leads us to the conclusion that CRAs are lagging instead of leading, that they are not very objective (they are influenced by the market) and that their methodologies are very opaque, as we have only the results of their actions to infer from. Furthermore, they are hardly accountable for their actions. The only logical conclusion from these observations is indeed that accounting standards, prudential regulation and central banks should attribute a much lower value to ratings. Instead, market participants and regulators should rely more on their internal models. This, however, requires regulation on transparency of rating methodologies and the data used, which is exactly what the European Parliament suggests.

In the next section, we will consider these suggestions and the resulting new regulation proposed by the European Commission.

Figure 1: Ratings versus spreads

Source: Bond yields for spread calculations are downloaded from the ECB's Statistical Data Warehouse.

Note: these figures plot the 10 year government bond yield spread over the German Bund on the left axis in percentages, and the ratings of these bonds by the big three rating agencies on the right axis according to the 58-point scale by Alsakka and ap Gwilym (2011).

3. GOING FURTHER

The European Parliament suggested several reforms to the existing regulation 1060/2009. It starts with eliminating the reliance on external ratings and increasing the ability of financial market participants to perform due diligence. Additionally, the ECBs decisions on collateral requirements should not depend on external ratings any longer. Furthermore, barriers to entry for new CRAs have to be removed. The European Parliament wants to foster cooperation among smaller CRAs to increase their market power, and wants to consider the setting up of a European Credit Rating Foundation. Related to decreasing reliance on external ratings, the European Parliament also advocates increasing the disclosure of information used for ratings so investors can perform their own analysis. For sovereign debt, this is already quite well possible, since the information is publicly available. Finally, the governance and accountability of CRAs has to be improved to make them more independent and thus able to provide better quality ratings.

The European Commission (EC) has adopted several of the recommendations, such as enhancing disclosure requirements, tightening reporting requirements concerning sovereign debt ratings, increasing the liability of CRAs and improving their governance. The EC has also indicated, however, that the creation of a European Credit Rating Foundation suffers from serious credibility issues; this has also been highlighted by several authors in our literature section. Instead, the EC prefers the creation of a network of rating agencies to enhance cross-border cooperation and reduce barriers to entry.

Although this is a significant step in the right direction, there are still several points to consider. First, there is still an oligopoly of CRAs who have strong market power, but are deeply flawed. An increase in competition should also increase the quality of ratings, but as of now there is not much stimulus to competition. On the contrary: the proposed regulation concerning registration and compliance creates even more (administrative) barriers to entry, as also argued by De Haan and Amtenbrink (2011). Second, these CRAs are not liable for their actions, i.e. they are not confronted with the consequences of their ratings and outlooks. Both these problems are partially addressed in the proposed regulation. Finally, external ratings are still relied upon to a too large extent. This is addressed in the proposed regulation by substituting them for internal ratings. However, the validity of internal models, and especially their verification by regulators, has been a point of heavy discussion.

What are the alternatives? Several suggestions have been made, such as transforming rating into a public service (i.e. by nationalizing CRAs or setting up a European Rating Agency), stimulating competition and cooperation between small rating agencies, or even delegating the task of providing (sovereign) ratings to the ECB. The first option has been proposed by the European Parliament, but has been criticized heavily (e.g. in the September/October 2011 *Intereconomics Forum* issue) for lacking credibility. Especially during these times of crisis, a European agency rating European sovereign debt will not be taken very seriously by investors. Furthermore, by legitimizing ratings this solution creates even more reliance on external ratings instead of internal analyses. However, an intermediate solution has been suggested by Welfens (2010), to overcome conflicts of interest and credibility issues. In his solution, bond issuers will pay their fees into a fund, whose management will then delegate the bond rating to designated agencies. If a European Rating Agency is set up in this way it will not issue ratings itself, but will function as an intermediary between issuers and raters, hereby sidestepping conflicts of interest and credibility issues.

The second option of stimulating competition seems a viable alternative, but the costs of setting up a rating agency, entering the market and building up a credible reputation are still very high. These costs are not diminished by the registration and compliance requirements suggested by the EC.

The last option, delegating the rating of sovereign debt to the ECB, has obvious advantages: the ECB has strong expertise in judging fiscal sustainability and is an independent body. This means that it can provide a credible assessment of the credit risk of sovereign debtors. However, the ECB's mandate is already quite broad, and has become even broader with the setup of the European Systemic Risk Board (ESRB). Perhaps an intermediate solution, modeled after the same ESRB, can be possible: set up an independent rating agency that makes use of the expertise of the ECB. Nevertheless, credibility considerations have to be taken into account very carefully also in this case.

4. CONCLUSION

Rating agencies are lagging behind markets in their judgment, as follows from the subprime crisis and from analyzing the current sovereign debt crisis. Furthermore, their business model is flawed as they face major conflicts of interest and are very opaque in their methodologies. Also, the oligopolistic structure of the ratings market provides the three large CRAs with a very strong position, while new entrants have the greatest difficulty to enter this market.

We must reduce the reliance on these bad ratings, by attaching less importance to them in prudential regulation and accounting standards. Furthermore, more competition is needed to increase the quality of ratings. To facilitate this competition, the interpretation of ratings and to improve investors' own analyses, more transparency is also needed.

Finally, several policy options to change the ratings industry have been put forward, including a network of small agencies, a European Rating Agency, or even the delegation of sovereign rating to the ECB. The first option is least preferred, because of the entry costs, coordination problems and the lack of economies of scale. The delegation of sovereign rating to the ECB would in principle be possible, but not preferable as it leads to a conflict of interest within the ECB. That leaves only the option of a European Rating Agency as a way to improve rating quality and transparency. However, it also requires high investment costs and time for reputation building.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
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Euro Area Sovereign Debt Crisis and Rating Agencies

Guillermo DE LA DEHESA

NOTE

Abstract

Ratings are a public good, and should therefore be improved, enhanced and globalized. The best solution for the intrinsic problems of Credit Rating Agencies (CRAs) is a correct regulation and supervision. Both should be based on harmonized global standards. In this process the US and Europe should take the lead. A level playing field would help to develop a larger market and creates incentives for more entrants in the present oligopolistic market and could therefore lead ultimately to more competition.

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EXECUTIVE SUMMARY

Credit Rating Agencies (CRAs) were created to mitigate problems of asymmetric information in debt securities markets between debt sellers or issuers and debt buyers or investors. Therefore, they are a public good. When they were being paid by investors they did not have a conflict of interest because their incentives were aligned; since 1972, they started to be paid by issuers and enter into conflicts of interest. CRAs have several other intrinsic problems of market concentration, barriers to entry, liability and others, which have been realized by investors and that should be fully addressed by regulators and supervisors.

Their largest conflict has been in the rating of structured financial products and their different tranches which were critical in unchaining the financial crisis in 2007-2008. In the present sovereign debt crisis their badly timing and sometimes contested sovereign ratings have helped to produced cliff effects and contagion.

Separately, both the US and the EU have increased notably their regulation and supervision of CRAs to reduce their intrinsic problems and align properly their incentives. It would be extremely important to introduce a level playing field and to achieve global standards to achieve a more efficient CRAs system which allows more competition and new entrants to reduce its oligopolistic nature. The ECB is fully supportive of the EU efforts to regulate and supervise CRAs in order to reduce their conflict of interest, their transparency and their efficiency.

The idea of a totally independent European CRA, but publicly sponsored and financed by the European Commission, specialized in sovereign ratings, would most probably fail because investors would become suspect about its true independence. Alternatively, a CRA sponsored by the ECB would be a non starter because the ECB would be rating its own shareholders and because it is beyond its mandate.

1. INTRODUCTION

Credit Rating Agencies (CRAs) have been designed and created to mitigate the large problems of asymmetric information existing in debt securities markets between debt issuers or sellers and debt investors or buyers, in order to avoid finance directors of private companies and/or treasury directors of governments cheating or not providing enough information to investors about the solvency of their debt securities issues.

The main reason why CRAs were created was to allow investors in debt securities to have access to a trusted, independent and credible third party opinion, in order to avoid taking excessive default risks that they were not able to guess directly, as well as to allow them to check if their fund managers were taking excessive risks.

CRAs business models are based on the fact that they are able to pool very large amounts of information about the solvency of debt securities; such information is extremely difficult and expensive to be collected by individual investors, and CRAs are able to give a sound and independent advice service to the latter at a lower alternative cost.

CRAs have been given an even stronger and increasing role by regulators under the Basel II and Basel III agreements, as well as by the European CRD (Capital Requirements Directive), on the basis that they are supposed to produce a “global public good”, given that their ratings are public information which can be eventually used freely by investors, regulators and the public in general.

2. INTRINSIC PROBLEMS WITH CRAS

There are several intrinsic problems with CRAs that tend both to reduce the efficiency and accuracy of their ratings and to produce conflict of interests:

1 - From their start in the 1930s and until 1972, they were paid by investors, which were buying debt securities and taking their risk of default, and, for that reason, they needed an independent and trusted third party rating advisor. Therefore, the largest and most frequent debt investors were subscribing to their rating services to reduce or minimize default risk. This traditional remuneration system was the right one and had the CRAs incentives rightly aligned, although it was somehow creating a “free riding” problem, because their ratings were made public and could be used by non subscribers as well.

Nevertheless, after 1972, they started to be paid by the issuers of debt securities, so that, they engaged in a serious conflict of interest because they were created for the opposite end, that is, to reduce the default risk of debt securities buyers by increasing their information about the risks of each debt security and by diminishing the probabilities of being cheated by their issuers.

2 - Until very recently (Dodd-Frank Act 2010), CRAs were not legally liable for their ratings in case these were proved to be wrong. Unlike auditors, they have achieved legal immunity, when being prosecuted by investors, because they are registered only as “financial journalists” which are protected by the 15 December 1791 First Amendment of the US Constitution, which established several freedoms, under the Bill of Rights, including, freedom of speech and freedom of the press. Therefore, they exclusively were living on their “reputational capital”.

By contrast, their income was mainly due to having been able to obtain a license given by the Securities and Exchange Commission (SEC), the US regulator, to become a Nationally Recognized Statistically Rating Organization (NRSRO) which gives them a special and privileged status to conduct their business, which becomes oligopolistic by nature. Therefore, they are an oligopoly blessed by the market regulatory authorities and, at the same time, they could not be taken to court if they were wrong in guessing the probability of default of their rated debt securities.

3 - There are very few CRAs because: first, there are large barriers to entry in their market, given that it is very difficult to become a NRSRO; second, their network externalities are very large and third, the efficiency argument enhances their concentration because it is the way to avoid duplicating the large effort by issuers to generate information that becomes free of access to others and the public in general (you may consider to make clearer this last sentence).

Some economists believe that there is a de facto duopoly, because the two largest have 80% of the market and the third one another 18%, and there are another 150 smaller CRAs in the world. In that case, it would be better if this duopoly became a monopoly, because issuers would not be able to go from one CRA to another pitching for a better rating as they do now (Bolton, Freixas and Shapiro (2009)).

4 - This latter problem is derived from the conflict of interest of the different users of ratings, which tend to have diverging interests. Regulators and debt securities investors want a high quality rating in terms of research and analysis, which should be strict, independent and unbiased. Debt issuers, by contrast tend always to prefer more “favourable” ratings. As they are those which pay the CRAs, the latter become suspect of having a clear incentive to tend to be less strict with their ratings in order to get more business from the former.

5 - CRAs, in order to perform their job, use not only public information, but also private information, which is not available to the public, which they obtain from their interviews and contacts with the top executives of their issuing clients. This “privileged, non public, information” could be used later to sell to the issuers other kind of related advisory services (Mariano, 2009)

6 - Although their price structure is well known and oversee by their regulators, they tend to bargain prices with their more regular clients for the following reasons: First, the issuer only pays the CRA if its debt security is issued with its given rating. Second, as the CRA gives its client a provisional rating, the issuer can have an incentive to turn it down, go to another CRA and try to get a higher rating. Third, the issuer can try, before going to another CRA, to bargain the rating with the first CRA in exchange of promising it more business.

7 - During the financial crisis, some CRA were suspect to have sold to the issuers consulting and advisory services as of how they should structure their CDOs and their respective tranches by using complex mathematical models, which could make them more efficient, less prone to default and, therefore, able to receive a better rating, which was given eventually by themselves.

8 - Some economists think that, in the case of complex structured products, the amount of information given by the issuers to the CRAs and by these to the final investors was very low, because issuers thought that it was better for them to give less information to all investors than to give more information only to the sophisticated investors, which would understand it better. In that way, they were convincing the less sophisticated investors that they were not going to lose more than the sophisticated ones or that the latter were not going to win more at their expense (Pagano and Volpin, 2009).

9 - Ratings tend to be pro-cyclical. Their relative changes, that is, their increases minus their decreases, tend to show a large pro-cyclicality. Therefore, they cannot be efficient at the time of preventing or avoiding large swings in financial markets prices because they tend to enlarge them, provoking uncertainty and “herd behaviour” among investors (Amato and Furfine, 2003). They also tend to provoke “cliff effects” where a downgrade of a single debt security can amplify pro-cyclicality and can cause cascading effects and contagion on other securities, as it has been happening during the euro area sovereign debt crisis.

10 - Ratings tend to be retrospective instead of forward looking. Moody's did not realize that Lehman could default and only reduced its rating four days before it defaulted and S&P reduced Lehman rating the same day of its default, creating a huge loss of confidence in their ratings, herd behaviour and contagion. Something similar happened to AIG and Washington Mutual ratings.

11 - CRAs only rate debt securities' probability of default, recovery in case of default and correlation of defaults (for investments with multiple assets) but not their market and liquidity risks which also affect decisively their risk of solvency and default. They were using the same rating methodologies for highly rated debt securities issued by sovereigns, which were traded massively everyday in regulated exchanges with a high level of liquidity, as for tranches of CDOs which were only sold and bought bilaterally between unknown buyers and sellers in illiquid “over the counter” exchanges.

12 - CRAs ratings methodologies are difficult to understand, given that are based on probabilities of default of a debt security and only on its relative probability of default in relation to other debt securities of the same or similar issuers, not providing numerical estimates of default of each security.

As a result of these 12 intrinsic issues, CRAs ratings of “structured financial securities” such as CDOs and CLOs and their tranches were abnormally high and prone to failure. As a consequence, structured securities tranches rated AAA came down from a value of 100, in

August 2007 to 23, in December 2008 and those rated AA came down from a value of 100, in 2007 to only 4, in 2008, generating a huge lack of confidence by investors on ratings. These large failures in the ratings of these structured products, which contributed at the peak to more than 40% of the CRAs revenues, proved, once more, some of the intrinsic issues and conflicts of interest of CRAs.

But, even after having realized these large rating failures, simultaneously and surprisingly, regulators, under Basel III, were giving CRAs more rating power and more over reliance by investors than ever before in history!

As a reaction to these failures, a round table of financial economists, assembled in December 2008, proposed that CRAs should increase the transparency of their models, methodologies and practices, that they should be able to be legally prosecuted in case of negligent errors and that public authorities should not delegate their regulatory responsibility to private companies (Goodhart, 2008)

Other economists did show a great degree of skepticism about these measures until the remuneration incentives issue was not changed. That is, CRAs should come back to be remunerated by debt securities investors and not by debt issuers. This serious issue of allying remuneration incentives to end results was somehow similar to another previous case. This was that of the analysts of investment banks, who recommended investors on which shares should they buy or sell, but they had a conflict of interest by being paid by the same investment banks. This problem was finally solved when investment banks were prohibited to fix their remuneration and when analysts were finally paid according to their verified recommendations success (Krawcheck, 2009)

Finally, other economists have conducted research about the interaction between the existing "issuer pays" model of the CRAs and the regulatory use of ratings, such as the use of credit ratings to determine bank capital requirements. They found that, in the absence of regulation, CRAs publish informative ratings, but rating precision tends to be suboptimal. The direction and magnitude of the deviation from the "social optimum" is directly linked to the average quality of the issuers, the complexity of the assets to be issued and the issuers' outside options, as potentially represented by other rating agencies and other sources of financing. They show that introducing rating contingent regulation that favours highly rated securities may mitigate (or amplify) this suboptimal behaviour, but if sufficiently large, always leads to regulatory arbitrage, rating inflation and complete breakdown of the delegated information acquisition (Opp, Opp and Harris, 2011).

3. CRAS NEW REGULATION AFTER THE FINANCIAL CRISIS

In the US, there was a pre-crisis Credit Rating Agency reform in 2006, in 2010 the Dodd-Frank Act was passed and signed into law, followed by further “Studies”.

In the EU, self-regulation was done before the crisis via an IOSCO (International Organizations of Securities Commissions) Code of Conduct. In December 2010 the Regulation (EC) 1060/2009 of the European Parliament and of the Council of 16 September 2009 (referred to as CRA1) entered into force. On 11 May 2011, an amendment to the previous Regulation on CRAs was adopted, adapting it to the creation of ESMA - European Securities and Markets Authority (Regulation (EU) 513/2011, referred to as CRA2).¹

Finally, on 15 November 2011, the European Commission has proposed a Directive and Regulation to the European Parliament and the Council (referred to as CRA3) with the following four main goals: i) ensuring that financial institutions do not blindly rely only on credit ratings for their investments; ii) more transparent and more frequent sovereign debt ratings; iii) more diversity and stricter independence of credit rating agencies to eliminate conflicts of interest and iv) making CRAs more accountable for the ratings they provide.

1 - New oversight institutions have been introduced: In the US, an “Office of Credit Ratings” has been created within the SEC. In the EU, the 2009 regulation included a registration process and a college of supervisors under the CESR (Committee of European Securities Regulators) guidance. In the Regulation (EU) 513/2011, the supervision was given to a centralized authority: ESMA (European Securities and Markets Authority).

ESMA is an independent EU authority, which will contribute to the stability of the European financial system by ensuring integrity, transparency, efficiency and orderly functioning of securities as well as enhancing investors protection. ESMA fosters supervisory convergence among securities regulators and across financial sectors by working closely with the other European supervisory authorities competent in the field of banking (EBA) and insurance and occupational pensions (EIOPA).

2 - New sanctions have been introduced: In the US the Dodd-Frank Act allows the SEC to bar NRSROs, and to suspend and revoke the NRSRO registration for a particular class of securities. In the EU, ESMA can withdraw registration of any CRA if it no longer meets the conditions or in case of serious or repeated infringement of the regulation.

3 - Regulation of symbols: In the US, Dodd-Frank Act Section 938 allows different symbols for different types of securities and to apply any symbol in a manner that is consistent for all types of securities for which the symbol is used. In the EU, Art 10 of Regulation (EC) No 1060/2009 obliges CRAs to use different rating categories for structured finance instruments which need to use an additional symbol, which distinguish them for rating categories used for any other entities, financial instruments or financial obligations.

4 - Disclosure requirements: In the US, according to Section 932 of the Dodd-Frank Act, CRAs should publish annual reports to the SEC and to the public, including internal controls, compliance, employment transitions, ratings performance transparency, methodologies etc. In the EU, Recital 25 of Regulation (EC) 1060/2009, requires disclosure of methodologies, models and key ratings assumptions, but not of sensitive business information. Article 12 requires annual transparency reports and Article 11 requires information on historical performance collected in a central repository.

¹ See also: http://ec.europa.eu/internal_market/securities/agencies/index_en.htm

5 - Conflict of interest: In the US, Section 932 of the Dodd-Frank Act, within the governance rules, includes a look-back requirement: CRAs shall i) conduct a review to determine whether any conflict of interest of the employee influenced the credit rating and ii) take action to review the rating, if appropriate. In the EU, Recital 26 of Regulation (EC) No 1060/2009 requires: internal policies to prevent, identify, eliminate or manage and disclosed conflict of interest. Recital 22 and Article 6 prohibit ancillary services if this activity creates conflict of interest with the issuing of credit ratings.

6 - Alternatives to the “issuer-pays” business model: In the US, Senator Franken introduced an amendment by which a central board would have assigned CRAs to provide credit ratings, but the House of Representatives did not accept it in the reform bill. According to the Dodd-Frank Act, two studies have to be conducted on this topic: i) Government Accountability Office study on alternative business models (Section 939D) and ii) SEC study on rulemaking on assigned credit ratings (Section 935F). In the EU, the public consultation on CRAs is discussing on alternative business models: i) Investor-pays model, ii) Payment-upon results model, iii) Government as hiring agent model, iv) Public utility model.

7 - Reducing over-reliance on CRAs: Over-reliance can be of regulatory or behavioral nature.

i) Regulatory reliance: rating-based regulations such as bank capital requirements in Basel II and Basel III, as investment restrictions on certain categories of investors, as well as collateral policies of central banks.

ii) Behavioural reliance: Rating triggers in contracts (rating-based termination provisions and internal investment guidelines) as well as rating-dependent “collateral triggers” in contracting.

In the US the Dodd-Frank Act includes in Section 939 (a-f) a removal of statutory reference to credit ratings and, according to Section 939A, every federal Agency has 1 year to remove regulatory references to credit ratings. The private sector should follow the step to avoid behavioural reliance.

In the EU: in the public consultation on CRAs there was a discussion about over-reliance on credit ratings, on the importance of market participants’ own due diligence and internal risk management, as well as considering alternatives to credit ratings such as internal models and market data. Finally, in July 2011 the Commission proposed a new Directive in the context of the so-called CRD IV reducing the number of references to external ratings and requiring financial institutions to do their own due diligence.

8 - Reducing the systemic importance of credit ratings: the FSB principles for reducing reliance on credit ratings (October 2010) includes:

- Financial stability-threatening herding and cliff effects showing that rating downgrades can amplify pro-cyclicality and cause systemic disruption;
- Importance of market participants own due diligence;
- Ending the mechanistic reliance on credit ratings following several principles:
 - i. for regulators: replacing regulatory references to credit ratings by suitable standards of creditworthiness;
 - ii. for market participants: encouraging market participants to improve their risk managements and avoiding the use of rating triggers;
 - iii. for central banks: promoting independent evaluations.

9 - Liability: In the US, the Dodd-Frank has ended the free speech privilege of CRAs and has introduced a liability regime through two dispositions of securities laws. Section 933, State of mind and Section 939G, Expert Liability. In the EU, within the Public Consultation on CRAs, is addressing Civil Liability.

10 - Enhancing competition in the rating industry: In the US, the CRA Reform Act of 2006 introduced competition as a leading objective, but it brought several counterproductive effects, namely “rating shopping” and “race to the bottom”. This because it is not possible to enhance competition so long as CRAs perform a regulatory function more than a private function; therefore it is better to restore market forces prior to increasing the number of CRAs. In the EU, within the Public Consultation, there is the political idea of promoting the establishment of a European CRA, the proposal of introducing new players and of lowering barriers to entry.

In sum, there are three clear trends in regulation on both sides of the Atlantic: first, more regulation and more oversight of CRAs; second, less use of credit ratings and third, find alternatives to credit rating models and eventually to the credit ratings themselves.

The Commission's new proposal on credit rating agencies for a Directive and Regulation (CRA3)

The very recent Directive and Regulation on credit rating agencies proposed by the European Commission on 15 November 2011 introduces further advances in the regulation:

1 - It reduces the number of references to external ratings not only for financial institutions (and requires them to do their own due diligence), but it introduces the same rules to fund managers to be applied to insurance companies next year. It also introduces a general obligation for all investors to do their own assessment. In addition, more and better information underlying the ratings would need to be disclosed by CRAs and by the rated entities themselves, so that professional investors will be better informed in order to make their own judgment. CRAs should communicate their ratings to the ESMA which would make sure that all available ratings on debt market instruments are published under the European Rating Index (EURIX) making the ratings freely available to investors. Moreover, CRAs will have to consult issuers and investors on any intended changes to their rating methodologies. Such changes should be communicated to ESMA.

2 - Member States would be rated more frequently, every six months rather than 12 months, and investors and Member States would be informed of the underlying facts and assumptions on each rating. Sovereign ratings should only be published after the close of business and at least one hour before the opening of trading venues in the EU.

3 - Issuers would have to rotate every three years between the agencies that rate them. In addition, two ratings from two different rating agencies would be required for complex structured finance instruments and a big shareholder of a credit rating agency should not simultaneously be a big shareholder of another rating agency.

4 - A CRA should be liable in case it infringes, intentionally or with gross negligence, the CRA Regulation, thereby causing damage to an investor having relied on the rating that followed such infringement. Such investors should bring their civil liability claims before national courts. The burden of proof would rest on the CRA.

In sum, these proposals seem to be going in the right direction in order to address two CRAs flaws: i) the near total domination by the big three CRAs and ii) the potential conflict of interest between CRAs and the issuers that pay them. At the same time, they try to reduce the addiction and reliance of investors and regulators to CRAs ratings and to increase and encourage the use of internal ratings. Finally they increase CRAs transparency about their methodologies to ESMA.

4. CRAS ISSUES DURING THE EURO AREA SOVEREIGN DEBT CRISIS

Leading CRAs have also been accused of exacerbating the Greek debt crisis by downgrading Greek bonds just as European officials were about to unveil a support plan, as well as of downgrading Portuguese bonds provoking cliff cascading effects.

It is true that there has been an interaction between ratings, short positions in the market and increasing use of the CDS market for default protection. There has also been a clear self-fulfilling interaction between rating downgrading and investors herd behaviour. But this tendency to herd behaviour is mainly a consequence of the huge uncertainty created among investors by European leaders every time they meet. The management of this crisis will become a major lesson of business schools and schools of government at universities as how not to manage a crisis.

Investors, when facing increasing uncertainty, tend to achieve a situation of “bounded rationality” and this more limited rationality makes them to lose confidence and to herd. The problem is that when investors herd, they reach quickly “multiple equilibria” which tend to be extreme. Since the start of the euro area, investors have shown extreme confidence on the monetary union and spreads of most Member States over the bunds benchmark were ridiculously low.

For instance, Spain’s sovereign debt maintained for a long time a spread of 3 basis points versus that of Germany, which was clearly an investor’s mistake of overconfidence on Spain. When the crisis started with Greece in October 2009, investors lost confidence on how the debt crisis was being managed, not only for not letting the IMF resolve the Greek crisis and later reschedule its debt, but for not taking a rational action to avoid contagion.

At the time of writing this briefing paper, in the middle of the growing euro area sovereign debt crisis, France, which is AAA, has a CDS that is the double of that of Chile, which is A+, and higher than those of Mexico and Brazil, which are BBB. Spain, which is AA-, has a CDS which is almost three times higher than that of Chile and two times higher than of those of Mexico and Brazil.

Apparently, this does not make any sense. Either investors who ask for protection in the CDS market do not pay any attention to ratings, or they are useless for them. These discrepancies may be due to different causes. First, to the fact that ratings are long term and CDS spreads are at very short term. Second, CDS spreads are a real market price which changes continuously while ratings are an opinion that changes once or twice a year. Third, ratings only assess the probability of default and CDS also take into account liquidity and depth in the market.

5. THE ECB VIEWS ON CRAS REGULATION

Price stability and financial stability are the two main objectives of the ECB. Therefore the ECB must be very worried about the important effects that the perceived existence of shortcomings in the rating activity performed by CRAs may have on market confidence and their possible adverse effects on financial stability. Even more, when medium term price expectations are below target and, by contrast, increasing sovereign debt problems, herd behaviour and contagion, are affecting very seriously the financial stability of the European banks and other financial institutions, which, in turn, are affecting the monetary transmission mechanism of the ECB's monetary policy, which is essential to meet its price stability objectives.

The ECB presented its views on the regulation of rating agencies on several occasions:

- ECB opinion CON/2009/38 of 21 April 2009² on the 2008 Commission proposal for a regulation on credit rating agencies
- ECB opinion CON/2010/82 of 19 November 2010³ on a proposal for a regulation amending Regulation (EC) No 1060/2009 on credit rating agencies
- In due time, it will most probably provide its views on the recent proposed Directive and Regulation of the EU Commission of 15 November 2011.

In February 2011⁴ the Eurosystem responded to the 5 November 2010 Commission consultation paper on credit rating agencies.

Its views are the following:

1 - The Eurosystem supports the Commission's efforts to reduce the reliance of financial markets and the official sector on CRAs ratings and to diminish the impact of "cliff effects" on financial institutions and markets. The ECB response says that the crisis has shown that the over-reliance on ratings, as they are embedded in many regulations and private contracts through rating downgrades (and their spillover effects) can destabilize financial markets. In that sense, the Eurosystem agrees with the Commission's approach consisting of two main pillars: first, requiring financial firms to undertake their own due diligence and internal credit risk assessment and second, reducing the reliance of regulation and supervisory practices on external ratings.

The Eurosystem presents a comprehensive stock-taking exercise of situations where CRAs ratings are embedded in regulations and private contracts, including the use of ratings in the collateralization requirements of OTC derivatives transactions. The crisis has shown that for the survival of firms and to preserve the broader financial stability, financial firms have to make their own credit assessment and due diligence of every transaction they contemplate entering should apply, following the principles of the FSB for reducing reliance on CRA ratings published in October 2010, which states: "Banks, market participants and institutional investors should be expected to make their own assessments and not rely solely or mechanistically on CRA ratings". This, in turn should ensure that financial firms should not invest or trade any product that they do not adequately understand or of which they cannot fully assess the risks.

The Eurosystem recognizes that, as shown during the crisis, inadequate expertise and excessive reliance on third party assessments are causes of mispricing, panic, sharp sell-offs and contagion.

² http://www.ecb.europa.eu/ecb/legal/pdf/c_11520090520en00010014.pdf

³ http://www.ecb.europa.eu/ecb/legal/pdf/c_33720101214en00010009.pdf

⁴ <http://www.ecb.int/pub/pdf/other/ecpublicconsultationcreditratingagencieeurosystemreplyen.pdf>

2 - The Eurosystem warns that vigilance is required regarding measures that would replace one credit risk measure (external rating) by a single alternative measure (single market measure). Hardwiring and automatic reliance on a single credit measure or single third party within regulatory/supervisory and market practices assessment should be avoided. As shown during the crisis these practices lead to forced selling, cliff-effects, severe downward spirals and contagion.

3 - The Eurosystem is cautious against any automatic reliance of regulation on market based variables. Market-based information may be excessively volatile and significantly misleading during times of market dislocation. In these situations, market information can be pro-cyclical resulting in mispricing over longer time periods.

4 - As regards sovereign risk ratings, the Eurosystem believes that internal capabilities to assess sovereign risk should be developed in the general investment framework and credit risk assessment of a financial firm, which should also include the distribution of exposures across several countries.

5 - Internal risk assessments may not be as broad as the ratings analysis from the CRAs and one should keep in mind that some investors and institutions may not have the economies of scale to do their own credit assessments.

6 - The Eurosystem suggests making a distinction between financial institutions' internal assessment and due diligence on the one hand and methods to calculate the required capital requirements on the other hand. Standardized approaches can be used to calculate capital requirements by smaller/less sophisticated firms, while still requiring that these firms develop adequate risk assessments and due diligence capabilities commensurate with their activities.

7 - The Eurosystem supports initiatives to enhance transparency and disclosure of the methodology and rating process in relation to sovereign debt. In addition, the harmonization of key definitions, such as sovereign default, would be welcomed as it would add clarity on the meaning of ratings by different CRAs.

8 - The Eurosystem agrees that sovereign ratings issued in a timely manner and accurately reflecting all of the available information would in turn contribute to reducing volatility of ratings themselves. However, some substantial issues related to the CRAs methodology for sovereign ratings would need further clarification. It is not clear how major facilities established to address the recent crisis, EFSM and EFSF, are evaluated by the rating of the countries concerned. Moreover, sovereign ratings should be reviewed more frequently and regularly at times of crisis. If, for example, CRAs issue regular reports (e.g. weekly) on their monitoring of sovereign under stress, the information shock of a downgrade could be better priced by the markets and multi-notch downgrades would not be necessary.

9 - CRAs should inform country's authorities ahead of the publication of a sovereign rating both for solicited and unsolicited ratings or reviews. Additionally, CRAs should explicitly indicate if a sovereign or supranational rating is unsolicited and the communication of the rating issuance should indicate in detail how the rating methodology departed from the one used for solicited ratings. Often, sovereign ratings do in fact influence markets, although more via credit warnings (outlooks, reviews, and watches) than actual rating changes.

10 - The Eurosystem fully supports measures aimed at increasing the disclosure, transparency and clarity of methodologies, models and assumptions parameters surrounding the approaches adopted by each CRA. Quantitative measures are only one part of the input into sovereign rating decisions. CRAs fail to publicly disclose details on the

precise functions and econometric models employed. Given the relatively small number of sovereign defaults, the methodology used by CRAs may not offer a reliable and consistent measure of the sovereign specific credit-worthiness. There is no harmonized definition of sovereign default among CRAs which is reflected also in the calculation of corresponding probabilities of default, so that a better standardization of definitions would help investors to understand ratings themselves and take actions, especially in times of crisis.

11 - The Eurosystem recognizes the issues related to the oligopolistic structure of global credit rating market dominated by a few CRAs and supports the importance of addressing the issue. There are different ways of addressing this problem. One is enhancing competition by facilitating market entry, by increasing transparency of credit ratings as regards data used, methodology and assumptions made by their models (USA). In this context, requiring firms to use at least two external ratings issued by different CRAs and to consider the exposure as unrated, unless at least two external ratings exist, would be easier to implement with a larger offer of external ratings than today. The Eurosystem would support provisions requiring hired CRAs to make accessible the data they received to non hired CRAs, when rating structured finance products and other instruments like corporate bonds.

12 - The ECB should not issue public ratings to be used for regulatory purposes. Notwithstanding, the Eurosystem fully supports the efforts to reduce the reliance of financial markets and the official sector on CRAs ratings and to diminish the impact of “cliff effects” of the regulatory use on financial institutions and markets. In this context the ECB itself started a process to enhance and develop further its internal capabilities for independently assessing the creditworthiness of issuers and issues eligible for credit operations and for critically reviewing external assessments. Every year, the ECB reviews the functioning of the Eurosystem Credit Assessment Framework (ECAAF) and allows the recognition, internally to the Eurosystem, of the four in-house credit rating assessments from four EU National Central Banks (France, Germany, Spain and Austria) (please check this last sentence).

13 - The Eurosystem believes that the idea of a European Network of small and medium-sized CRAs will help build up expert knowledge and improve methodologies, capable human resources, and data exchanges, development of common IT systems, internal controls and extra capacity that may improve the quality of ratings. Such a network could provide some support in the early stages of a CRA business being set up, each of the CRAs being specialized in different areas. The new CRA regulation also needs to avoid potential exit of some small and medium size CRAs.

14 - A high standard of civil liability for CRAs has been introduced in the US law and a similar standard should be further studied for the EU, making CRAs liable for the performance of ratings when they have failed to conduct reasonable investigation into the facts used by its methodology or verify them if obtained from other parties.

15 - The Eurosystem agrees that the current “issuer-pays” financing model of ratings can be a source of conflict of interest and thus may have a distorting influence on ratings. However, not just the type of payment model can lead to conflict of interest: the lack of transparency regarding payment models and modalities can also lead to less than ideal outcomes. The “subscriber-investor pays model” could be the alternative, but some US evidence shows that newly founded rating agencies are more likely to use the “subscriber-pays model” than the “issuer-pays model”, whereas the bigger CRAs use the “issuer-pays model”. However, it is unclear if this is due to timing or perhaps related to the smaller size and higher specialization of the smaller firms. Other models can also involve conflict of interest and bring distortions to the markets, albeit of a different kind.

6. COSTS AND BENEFITS OF A EUROPEAN RATING FOUNDATION

It is understandable to blame CRAs for having rated CDOs making type 1 errors, (a hypothesis such as an structured product is risky is rejected when it should have been accepted) and type 2 errors (a risky structured financial product is accepted when it should have been rejected) and having repeated the same two types of errors when rating European sovereign debt, when compared to similar ratings of the US and the UK sovereign debt (De Grauwe, 2009). It is correct to say that CRAs should have been liable for their ratings on structured mortgage financial products that unchained the financial crisis, however they cannot be blamed for having created the European sovereign debt crisis, but for having exacerbated it with badly timed downgrades, which have produced “cliff effects” and contagion.

The European sovereign debt crisis was announced since the beginning of the 1990s by many economists including myself (de la Dehesa and Krugman, 1992) because the EMU had from the start several design failures and later by basic crisis management failures. It has been made much worse by an incredibly slow and bad management by our European leaders that still carries on at the time of writing this briefing paper after two years, since the breakup of the Greek crisis.

Therefore, the crisis is basically the result of a combination of design and management failures. At the beginning of the euro area, investors trusted fully the EMU, but later realized that the euro area was not an optimal currency area, did not have a lender of last resort in the ECB and did not have a common fiscal policy or, at least, a very large community fund to face asymmetric shocks in Member States. After these discoveries, investors found out that European political leaders were not prepared to fix these design failures.

The non-legislative resolution of the European Parliament, in June 2011, included asking the European Commission to study the potential creation of a new totally independent European Credit Rating Foundation (ECRaF). In principle, given the oligopolistic structure of the supply market for ratings, any new entrant should be welcomed. Nevertheless, it would be a novelty in the market of CRAs, given that, until now, CRAs have been created by the private sector and not promoted by a public body and even more so by a European public institution.

This new ECRaF should not be publicly sponsored even if the Commission would only put seed capital and development capital until the ECRaF would raise enough private capital, because it would not be considered independent and trusted by investors, even more when it would specialize on sovereign ratings. I cannot imagine the European Commission acting as a venture capitalist of the Foundation.

Investors would not take seriously its sovereign ratings because they would find them biased by political interference if the Commission would promote it. The ECRaF should be promoted by groups or associations of independent European investors to have a fourth view on ratings, besides those of the top three oligopolistic CRAs. Being European would be better than being from a defined nationality, given that today sovereign debt securities are national.

Nevertheless, when most of the European issuance would become Eurobonds, if the ECRaF would be public the general suspicion about its lack of independence would be so large that it would fail to attract any investor attention. Therefore, it should be left to private investors, if they see an increasing development of the market for ratings, as it seems to be the trend today, to create new CRAs entrants to compete with the present top three CRAs. They would be much more credible than a publicly sponsored CRA.

Could the ECB be an independent provider of European sovereign credit ratings?

The ECB is in charge of the euro area monetary policy which should be able to achieve price and financial stability and that is already a difficult mandate and a huge task. Even if in the Lisbon Treaty its independence to take decisions is absolute, it should never be engaged in rating its own shareholders which are all the euro area Member States plus the rest of the EU Member States. It would not only be an oxymoron but also a dangerous decision with no support in the Treaties, which would not be approved by its Council because the ECB would lose independence and credibility.

CONCLUSIONS

As I mentioned at the beginning, ratings are a public global good, so that they should be improved, enhanced and globalized. Therefore, the best solution for the intrinsic problems of CRAs is a correct regulation and supervision, but both should be based on both harmonized and global standards. The US and Europe should take the lead and harmonize their standards, even if they not became identical. A level playing field would help the development of a larger market and also create incentives for more entrants to compete in the present oligopolistic market.

IOSCO could be the forum where to try to harmonize these standards but also a new global authority could be created, to which individual jurisdictions would delegate their supervision of CRAs (Véron, 2011)

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Ratings Agencies

Anne SIBERT

NOTE

Abstract

In this note the extent of the alleged problems in the credit ratings industry is assessed and solutions are suggested. The viewpoint of the ECB is noted and it is considered whether it or a new partially publicly funded entity could provide sovereign credit ratings.

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EXECUTIVE SUMMARY

- Until the early 1970s ratings provided little information to the market. Issuers were rated for free and raters sold books of ratings. This was not especially profitable. The ratings industry escaped regulation, probably because of its lack of importance.
- Two things changed the industry. Illiquid markets after the bankruptcy of the Penn Central Railroad in 1970 caused debt issuers to actively seek out ratings and ratings agencies began to charge issuers. Laws and regulations were made dependent upon the ratings of a small number of firms, making these ratings enormously important.
- Although the ratings agencies have been condemned for a number of recent errors in judgement, some studies show that rating changes do have informational value.
- The ratings industry is an oligopoly. However, some industries with few firms remain highly competitive. If the industry had a large number of small firms, each with its own metrics and standards, it might cause confusion for the users.
- The ratings industry faces conflicts of interest. Agencies are paid by issuers and the fee is a proportion of the issue's value. Ratings agencies sell consulting services as well as ratings. Their management may sit on the boards of the firms that they rate. Firms rate the sovereign debt of countries that regulate them. US-based firms dominate the industry.
- Following the past decade's financial boom and bust, credit ratings agencies have not only been charged as incompetent, but have been accused of behaviour that is overtly criminal. In particular it has been alleged that they extort firms that do not pay for ratings by giving them unsolicited ratings that are lower than they deserve.
- It is argued that banks, with the help of the ratings agencies, turned bundles of junk bonds into AAA tranches of CDOs, helping to fuel the growth of this dysfunctional market and thereby playing an important role in propagating the financial crisis.
- Ratings alone are a poor measure of risk, but the financial sector may have a culture of being overly dependent on them. The excessive importance placed on ratings could cause a rating change to make a fear or ebullience-driven market outcome possible. There is little evidence that this has happened in the current sovereign debt crisis.
- Credit rating firms should be registered but the NRSRO (Nationally Recognized Statistical Rating Organisation) designation should be eliminated. Registered firms should only be allowed to rate; they should not be allowed to provide other services or products. A rating agency should not be allowed to offer unsolicited ratings if it also offers ratings paid for by issuers. Senior managers should not sit on the boards of the firms they rate. Issuers should have to rotate raters.
- To help solve the problem of over reliance on ratings, to the extent possible regulation should depend on market-based measures instead of ratings. However, there needs to be flexibility in the case of market dysfunction.
- The ECB supports solutions that reduce over reliance on ratings and it wants more transparency with respect to sovereign debt ratings. Sensibly, it does not want to issue such ratings itself. Setting up a partially publically funded European rating foundation would be difficult and expensive and could not be done quickly and might also raise the barriers to entry in the industry, decreasing competition rather than increasing it. It would have a clear conflict of interest when rating sovereign issues or the issues of European agencies such as the EIB, the EFSF, the EFSM and the future ESM.

1. INTRODUCTION

The three big firms that dominate the credit rating industry have recently been viewed as incompetent, badly behaved and bumbling. They have been condemned for failing to downgrade mortgage-backed securities quickly enough and for not foreseeing the failures of Lehman Brothers and AIG. Their participation in the CDO market is seen as an important factor in worsening the financial crisis. They have been called extortionists who give unsolicited bad ratings to firms that do not employ them. Earlier this month Standard & Poor's accidentally released an erroneous message saying that it was about to downgrade French sovereign debt. In this note I provide a brief historical background of the credit rating industry and describe the two important changes that gave the industry its current business model and importance. I assess the extent of the alleged problems with the industry and suggest solutions. I note the viewpoint of the ECB and consider whether it or a new partially publicly funded entity could provide sovereign credit ratings.

2. SOME BACKGROUND ON RATINGS AGENCIES

In this section I describe how the credit ratings industry came to be and the two changes that gave it its current shape.¹

2.1 The Early Years

The ancestors of the modern ratings agencies were the mercantile credit agencies that rated merchants' abilities to repay their loans. These began following the Panic of 1837 when Louis Tappan left the silk trading firm that he ran with his brother and established the Mercantile Agency in New York in 1841. It operated by collecting information through a network of agents, including attorneys, bank cashiers, merchants and others and then selling this information to subscribers. In 1859 the agency was acquired by Robert Dun who changed its name to R.G. Dun & Company and published the Dun Book, its first reference book of credit information. A similar agency was formed by John Bradstreet in 1849 and it published a ratings book in 1857. In 1933 the two firms consolidated into Dun & Bradstreets.

The origins of the current big three ratings agencies go back to 1860 when Henry Varnum Poor published a comprehensive compilation of information about the fiscal state of US railroads. Together with his son Henry William he founded H.V. and H.W. Poor Co. which published annual updates of his compilation. In 1906 Luther Lee Blake founded the Standard Statistics Bureau with a view to providing similar information on non-railroad companies. The two firms merged to become Standard & Poor's Corporation in 1941.

Meanwhile, in 1900 John Moody & Company published Moody's Manual of Industrial and Miscellaneous Securities, providing information and data on the stocks and bonds of private firms and government agencies. The manual was a great success, but unfortunately it met its demise in the stock market crash of 1907. In 1909 John Moody rebounded with the idea of rating US railroad bonds and he extended this idea to utility and industrial bonds in 1913. By 1924 his service covered almost all of the US bond market.

The last of the current big three agencies to arise was Fitch. In 1913 John Knowles Fitch founded the Fitch Publishing Company. In 1924 it introduced its familiar AAA through D rating system.

From the 1950s through the early 1970s the ratings agencies constituted a rather uninteresting industry. It appears that their ratings provided little information to the market. According to a study of 207 corporate bond rating changes from 1950 to 1972, credit rating changes generated information of little or no value. Instead they merely reflected information that had already been incorporated into market prices.² This was hardly surprising as most of the information that the ratings agencies used was publicly available.

Up until the 1970s the ratings agencies followed the business model of rating companies for free and then publishing thick volumes detailing their results. These volumes were sold to investors. However this information could be easily copied and the ratings business was not a terribly profitable one. The ratings industry escaped regulation, probably because it was thought to be insufficiently important to bother with.

¹ Histories of the credit ratings industry can be found in Cantor and Packer (1994) and Partnoy (2009).

² See Pinches and Singleton (1978).

2.2 Two Things that Changed the Industry

Two things happened to change the fortunes of the ratings agencies and to turn them into the companies that they are today. The first was the bankruptcy of the Penn Central Railroad in 1970. At the time it was the largest corporate bankruptcy in US history and financial markets were stunned. Driven by fear, investors questioned the condition of other companies and refused to roll over their commercial paper. Faced with illiquid markets, issuers of debt began to actively seek out ratings. As a result both Moody's and Fitch began to charge issuers of debt in 1970 and Standard & Poor's did the same a few years later.

Under the new business model, issuers of debt provided substantial amounts of detailed private information to the ratings agencies. The agencies used this information as well as publicly available information to come up with a rating. The issuer then paid the ratings agency a fee that was proportional to the value of the issue. This new system had the potential to greatly increase the information content of the ratings, but as will be seen it also led to conflicts of interest, promoted the development of the collateralised debt obligation (CDO) markets which helped fuel the financial crisis and possibly led to significant explicit and implicit extortion.

The second thing that happened to change the ratings industry was when legislators and regulators made laws and regulations depend upon ratings. The origins of this go back as far as the 1930s. In 1931 the US Office of the Comptroller of the Currency ruled that banks had to mark to market bonds that had not been rated above speculative grade by at least one recognised ratings agency and in 1936 it prohibited them from holding such securities altogether. By recognised agencies it meant Moody's, Poor's, Standard Statistics Bureau and Fitch. When regulators made rules that depended upon a small number of company's ratings, they made these ratings enormously important.

In 1975, the US Securities and Exchange Commission (SEC) formulated risk-weighted capital adequacy requirements for banks and broker-dealers that depended on the safety of the assets held by these financial firms. To clarify these rules, the SEC decided to use bond's credit ratings as the measures of their risk. It then designated Moody's, Standard & Poor's and Fitch as the Nationally Recognized Statistical Rating Organisations (NRSROs) whose ratings would be used to assess whether the financial firms were satisfying the regulatory requirements. Currently bank capital requirements depend on ratings and so do the requirements of other private institutions. Many pension, insurance and money market funds have constraints based on credit ratings.

Partnoy (2001) describes the valuable property rights that come with NRSRO membership as regulatory licenses. Agencies have come and gone from the NRSRO list and there are currently nine, but the big three still account for the lion's share of the market.

3. PROBLEMS AND FEATURES OF THE CREDIT RATINGS INDUSTRY

In this section I consider some of the problems and features associated with the industry.

3.1 Do Ratings agencies Provide Useful Information?

The ratings agencies have been condemned for a number of recent errors in judgement. This raises the question: do ratings agencies provide useful information to markets?

In contrast to Pinches and Singleton's (1978) study of the earlier years of the ratings agencies, some studies of more recent years do show that rating changes have some informational value. Hand et al (1992) show that both stock and bond prices react to ratings changes. Empirical studies of the informational value of rating changes are made difficult because a change in a rating is usually triggered by some event and it is difficult to disentangle the effect of the change in the rating on a bond price from the effect of the event on the bond price. Kilger and Sarig (2000) cleverly sidestep this problem by looking at the impact of Moody's 1982 refinement of its rating scheme. They found that it did not change the total market value of borrowers but it did alter the share of debt and equity values.

An empirical study by Cantor and Packer (1996) shows that to a great extent Moody's and Standard & Poor's sovereign ratings assessments are explained by just a small set of variables: per capita GDP, GDP growth, inflation, external debt, the level of economic development and past default history. Moreover, the market's assessment of the relative risk of sovereign default, as measured by sovereign debt yields, is broadly similar to that of the agencies. However, rating announcements have immediate effect on market pricing, especially for sub-investment grade issues.

To summarise, it appears that changes in ratings do provide information to the market. However, some caution must be used in interpreting the above results. Ratings changes may change bond prices. Some of the change may happen because the market learns something about the creditworthiness of the issuer that it did not know before. However, some of it could be due to the regulations, institutional rules and the culture of the financial sector which could cause bond prices to depend on ratings through other channels than the information that they convey about the creditworthiness of the issuer.

3.2 Is the Credit Ratings industry's Oligopoly Structure Good or Bad?

The big three ratings agencies currently account for roughly 95 percent of the industry market share, with Standard & Poor's and Moody's each accounting for about 40 percent and Fitch for about 15 percent. The small number of large firms is not surprising as the required reputational capital alone would serve as a significant barrier to entry by other firms. This problem has been exacerbated by the importance of ratings in legislation and regulation and the SEC granting NRSRO status to a small number of firms.

The oligopoly structure is not necessarily a problem. Some industries with few firms remain highly competitive as can be seen from the UK supermarket industry, the US market for cola or the global civilian aircraft manufacturing industry. Little anti-competitive behaviour seems evident in the credit ratings agency industry. Moreover, if the industry had a large number of small firms, each with their own metrics and standards, rather than the big three it might cause confusion for the users.

3.3 Conflicts of Interest

The ratings industry faces a number of potential conflicts of interest. First, the agencies are paid by the issuer of the debt that it rates. This produces a temptation to give a better-than-deserved rating to increase its customer base and generate more revenue.

A second conflict is that, as previously mentioned, the fee charged by the ratings agency is a proportion of the value of the issue. As highly rated issues are more valuable than lower-rated issues, this tends to give the ratings agency an incentive to rate the issue more highly than it would if it were paid a flat fee, independent of the value of the issue.

A third conflict of interest is that the ratings agencies sell consulting services as well as ratings. A firm can hire a ratings agency to advise it on how to attain a rating and then use the same ratings agency to provide a rating. This may provide ratings agencies with an incentive to give better-than-deserved ratings to companies that purchase their advisory services and firms may feel pressured to purchase these services if they want good ratings.

A fourth type of conflict is that the management of the ratings agencies may have entirely too cosy a personal or professional relationship with the management of the firms that they rate. The saga of Moody's and MCI WorldCom is a particularly egregious example.³ It is common for credit ratings agency board members to serve in various positions for their corporate clients. Clifford L. Alexander, Jr. served as chairman of Moody's from Oct 2000 to Oct 2003. In addition, for almost 20 years up until the end of 2001, he was a member of the board first of MCI Communications and then of MCI WorldCom after MCI Communication's merger with World Com. Throughout this period Moody's gave good ratings to the communications company, continuing to do so even after the market treated its debt as junk. It was only in May 2002 that Moody's finally lowered its credit rating to sub-investment grade. On 21 Jul 2002 MCI WorldCom filed for Chapter 11 bankruptcy protection, at the time the largest such filing in US history.

A fifth conflict of interest is in sovereign debt ratings. Here the ratings agencies may be rating actual or potential regulators. Consequently they may have an incentive to placate them. That this happens, however, is not obvious. Standard & Poor's was willing to infuriate US policymakers with its recent downgrade of US sovereign debt.

A related sixth possible conflict is that Moody's and Standard & Poor's are headquartered in New York and Fitch is dual headquartered in New York and Paris. More than half of the big three firms' revenue comes from the United States. This suggests that the big three might favour US firms, especially firms in regulated industries such as banking and insurance that have US regulators and supervisors. However Véron (2011) argues that the management of the big three ratings agencies is multinational and there is little reason to believe that US institutions or the US sovereign are favoured.

If ratings agencies were solely dependent on their reputational capital, it is likely that the temptation to bias their ratings would be mitigated by the need to rate issues correctly if they wanted to survive and prosper. However, as long as a ratings agency possesses the regulatory license conferred by being an arbiter of whether or not an issue conforms to legal and regulatory guidelines, the ratings agency is apt to flourish whether or not its ratings are based on an unbiased view. Thus, it is not clear whether a ratings agency has an incentive to shade the ratings of good customers or not. In the industry's favour, Covitz and Harrison (2003) look at 2000 ratings changes between 1997 and 2002 and conclude that they appear to be primarily motivated by ratings agencies' desires to maintain their reputations rather than by conflicts of interest.

³ This story is told in Klein (2004b).

3.4 Do Ratings Agencies Extort Their Clients?

Along with being seen as incompetent, credit ratings agencies have been accused of behaviour that is overtly criminal. In particular it has been alleged that they extort firms that do not pay for ratings by giving them unsolicited ratings that are lower than they deserve.

The typical scenario in the credit ratings industry is that a firm approaches a ratings agency, pays a fee, provides private information and receives a rating. Sometimes, however, ratings agencies provide the rating for free without being asked to and without being given private information. This may lead firms to fear that if they do not purchase a rating they will be given one anyway and it will be less favourable than if they had paid. Two examples show that these fears may be rational.⁴

The first example involves a 1996 court case. The Jefferson county, Colorado school district hired Standard & Poor's and Fitch to rate its bonds after having used Moody's in the past. It priced its bonds and they sold well until Moody's issued an unsolicited "negative outlook". The school district was forced to lower the price of its bonds and it took Moody's to court. The ratings agency argued that its opinions were protected by the First Amendment right to free speech and the judge agreed.

In the second example, in 1998 Moody's informed the German insurance company Hannover Re that it would rate its debt for free, but looked forward to the day that the company would be willing to pay. Hannover Re was already paying large sums to Standard & Poor's and A. M. Best Co. (a specialist rater of insurance companies) and declined the offer. Moody's responded by rating Hannover Re's debt a notch below the rating given by Standard & Poor's. Over the years Hannover Re maintained good ratings from the two agencies that it paid while its rating from Moody's steadily declined; Moody's kept pressuring Hannover Re to purchase its services and the German firm kept refusing. Finally, in March 2003 Moody's cut Hannover Re's debt to junk, wiping ten percent off the value of its stock.

While these examples are alarming, it is unclear whether they are unusual events or whether the threat of receiving a poor rating is pervasive, perhaps so pervasive that unsolicited ratings are uncommon. One might wonder why a credit ratings agency would go to the trouble of issuing a rating without payment, other than to pose a threat. Ironically, however, US credit ratings agencies rely on being identified as financial commentators, similar to Reuters and the Wall Street Journal, to be able to argue that their ratings are free speech and that, consequently, they cannot be held legally liable for them. Issuing unsolicited ratings makes them appear more like commentators.

Testing whether rating firms systematically extort – explicitly or implicitly – client firms to purchase ratings is difficult. If an econometrician found that unsolicited ratings were lower than solicited ratings this could be for any of three reasons. First, it might be extortion. Second, there may be sample bias. It might be that good quality firms solicit ratings to signal that they are good quality firms. Third, when a firm solicits a rating it provides the rating firm with private information which may make it easier for the rating firm to provide a better evaluation. Poon (2003) uses data from 265 firms in 15 countries rated by Standard and Poor's over the period 1998 to 2000 and finds that unsolicited ratings are lower than solicited ones but that most of the difference is due to selection bias. Fairchild et al (2009), however, use a data set consisting of Japanese firms rated by Moody's and conclude that, even after correcting for sample bias, the unsolicited ratings are lower than solicited ones.

⁴ These examples are recounted in Klein (2004a).

3.5 The Role of Credit Ratings agencies in the Financial Crisis

Credit ratings agencies may have played a prominent role in the financial crisis. In this subsection I look at their involvement in structured investment products.

Partnoy (2006, 2009) argues that the importance attached to credit ratings played a key role in the growth of the dysfunctional market for collateralised debt obligations (CDOs). A CDO is created by setting up a special purpose entity that issues securities to investors in different tranches and uses the proceeds to purchase fixed-income securities. Investors are then paid off sequentially, depending on their tranche, so that those in lower tranches take losses before those in higher tranches. The volume of CDOs grew rapidly before the debt crisis. There were two reasons for this growth. The first was that banks wanted to get assets off their balance sheets to reduce their regulatory capital requirements. The second was arbitrage. Banks were able to create fixed-income structures where the combined worth of the tranches issued greatly exceeded the cost of the underlying assets. In synthetic CDOs no actual fixed-income securities were actually purchased. Instead the same credit exposure was attained by selling insurance on fixed-income securities using CDSs. Therefore the motivation appears to have been entirely arbitrage. But, how did those who structured these CDOs produce the magic of the whole being greater than the sum of the parts? In some CDOs the underlying securities were tranches of securities issued by other CDOs or even tranches backed by tranches backed by securities issued by other CDOs, making the transformation particularly hard to understand.

The key to the increase in value was not some traditional market failure such as illiquidity but rather the relationship between the credit ratings on the CDO's tranches and those on the underlying assets. The goal was to take underlying assets with a relatively low credit rating and produce a CDO with a large tranche that had a much better credit rating. Benmelech and Dlugosz (2009) document the mismatch that was achieved. They collected data on 3912 tranches of CDOs primarily backed by loans and found that 70.7 percent of the value of the securities issued by these CDOs were rated AAA while 85 percent of the collateral on the underlying loans supporting the tranches had a B rating, eight percent had a BB rating and for the rest the data were missing.

How was the alchemy of turning underlying junk into AAA tranches achieved? Since both bankers and credit ratings agencies earned huge fees from an increase in value, they had an incentive to use flawed models that would produce the desired transformation. The ratings agencies would produce an imperfect methodology, perhaps one that depended on inapplicable historical assumptions, and then the bankers who produced the CDOs would choose the underlying securities and the structure to create an outcome consistent with both high fees for those involved and an appealing return for investors.

Ironically, the banks sometimes even managed to fool themselves with their transformative sorcery. Since the beginning of the financial crisis, the Swiss bank UBS has been forced to write down about USD 50 billion of mortgage-related assets and, at the end of 2007, 'super senior' tranches contributed to about half of this loss. The super senior tranche is the most protected tranche of a CDO, receiving payment before all other tranches, although there is still potential risk. When UBS's investment banking unit considered the riskiness of the super senior tranches for its value at risk analysis it used the AAA ratings assigned to these tranches by Moody's and Standard & Poor's. It appears that the unit made no attempt whatsoever to investigate the fundamentals of the US housing market.⁵

⁵ See Shefrin (2009).

3.6 Are Investors Overly Reliant on Ratings? Is the Market?

The letter grade given to a bond issue indicates solely the ratings agency's assessment of the likelihood of a default. There are inherent problems in relying on the grade as an assessment of risk.

One problem is that ratings merely give a measure of the likelihood of a default. But, they do not say if the issuer is more likely to default in good times or in bad times. A default in good times is less harmful than a default in bad times so if two firms have the same probability of defaulting, but one defaults in good times and one in bad then all other things being equal the value of the bonds of the firm that defaults in good times should be worth more than the value of the bonds of the firm that defaults in bad times.⁶

A second related problem is that for an individual market participant the assessed probability that default will occur can say little about how purchasing this bond will affect the riskiness of his portfolio. To see this, imagine a world where it will either be sunny all next year with high probability or rainy all next year with low probability. Umbrella bonds are rated junk because umbrella companies default in the likely event of sun; beach ball bonds are highly rated because beach ball companies only default in the unlikely case of rain. For a beach chair manufacturer, however, it can be less risky to buy the junk umbrella bonds than the higher rated beach ball bonds.

A third problem is that the financial loss associated with a default depends on the expected loss conditional on a default occurring or, equivalently, on the recovery rate in the event of a default. A low probability of default, but with a low recovery rate if default occurs, may be more damaging than a higher probability of default but with a lower expected loss, if the default occurs. A fourth problem is that the rating says nothing about the risk of price volatility or illiquidity.

Recall from the previous subsection that the staff of a large investment bank was able to fool themselves into thinking that their senior tranches of CDOs were safe because they had a AAA rating even though it was they who had contrived to make AAA tranches out of junk. Paying inordinate attention to ratings appears to have been part of the culture of the financial sector.⁷ This culture could not only be harmful to an individual institution that puts too much weight on ratings, it could affect the market as well. There is no substitute for due diligence by investors or their agents engaging in fundamental analysis to evaluate default risk and other relevant characteristics of the bonds they are considering investing in. Ratings too often make for lazy and careless investors.

The possible over-importance of and over-reliance on credit ratings raise the possibility that credit rating changes could be *sunspots*. Sunspots are typically variables that are intrinsically unimportant to the economic environment but that can affect the economic outcome anyway, even when market participants are rational. They can also be variables that have some intrinsic importance but affect markets far more than they would solely do in their role as fundamentals. Given that credit rating changes convey some information, we would expect price movements after a ratings change. But, it appears that they could have a far greater influence than simply disseminating information.

⁶ See Morrison (2009).

⁷ See Partnoy (2009).

Financial asset markets can be driven by fear and ebullience. A borrower, be it a firm or sovereign, might be able to pay its debt as long as it faces reasonable borrowing costs. But if all market participants were to believe that it is unlikely to be able to pay, then it will not face reasonable borrowing costs and it defaults. The markets expectations are self-fulfilling. Normally fear-driven outcomes do not occur without a reason. Credit ratings, however, are sufficiently important that a change in a rating might be such a reason.

While it seems theoretically possible, there is little evidence yet that credit rating changes have acted as sunspots. Véron (2011) argues that it is not obvious that any sovereign downgrade has had a significant effect on market sentiment during the current euro-area crisis.

4. HOW CAN THE CREDIT RATINGS INDUSTRY BE IMPROVED?

The results of the last section suggest that the credit ratings industry is probably conveying useful information. Its natural oligopoly structure is not obviously undesirable, although of course competition authorities should punish any observed anti-competitive behaviour. The main problems are possible conflicts of interest; some egregious examples of bad behaviour; the involvement of the industry in creating structural investment products; and an over-reliance on credit ratings.

4.1 Getting Rid of Conflicts of Interest, Egregious Bad Behaviour and the Credit-Ratings industry's Involvement in Creating Structured Investment Products

Credit rating firms should be registered with the SEC in the United States and the ESMA in the European Union. To maintain registered status they should have to provide regular evidence of competency. However, the restrictive NRSRO designation should be eliminated in the United States. This would boost competition and help ease the problem of over-reliance on credit ratings.

To remove the conflicts of interest, registered credit rating agencies should only be allowed to provide ratings to firms and other debt-issuing entities, including sovereigns. They should not be allowed to provide consulting services and they should not be allowed to assist in building structured investment products. Senior managers of registered credit rating agencies should not be allowed to sit on the boards of any company issuing debt rated by a registered credit rating agency. Firms should rotate credit ratings agencies on a specified regular basis. This will solve both the problem of rating firms being tempted to give clients overly good ratings and it will help solve the problem of credit ratings agencies extorting potential clients.⁸

Registered firms should not be allowed to provide unsolicited ratings if their business model is payment by the issuers of securities. They should only be allowed to provide unsolicited ratings if their business model is payment by the investing public. This would solve the problem of extortion and end market confusion on how to interpret unsolicited ratings. It will also firmly establish that registered credit rating agencies that are paid by the issuers are not financial commentators and, therefore, are not protected from being sued in court for egregious behaviour on free speech grounds.

Not allowing registered firms to do anything but rate would end their involvement in structured investment products. However, there may be an argument for disallowing the issuance of any financial products which exist solely due to rating arbitrage. Synthetic CDOs and CDOs raised to any power greater than one should be illegal unless a financial institution can demonstrate some other reason for their existence.

4.2 Solving the Problem of the Over Reliance on Ratings

Credit ratings gained undue importance when ratings and rating requirements became common place in legislation and contracts. Examples include their use in determining Basel II capital requirements and the ECB's use of them in determining what collateral was acceptable in its lending operations. To get rid of this undesirable legislative and regulation-driven importance of ratings – a result of dysfunctional private provision of public goods – these rules and regulations should be rewritten where possible.

⁸ If either of these problems were more severe than they appear to be, the SEC or ESMA could allocate firms to ratings agencies.

The problem is that clarity and fairness are frequently enhanced by a precise specification. In contracts a precise specification is a key. To a great extent, however, it may be possible to replace ratings with a market-based measure such as bond spreads. The problem with this is that in periods of illiquidity markets may become dysfunctional. In these rare times the regulatory authority might be given the power to temporarily replace spreads with ratings.

4.3 What Does the ECB Think?

The ECB is concerned with financial firms' and markets' over-reliance on credit ratings.⁹ It would like financial firms to undertake their own internal risk assessments and wishes to reduce the reliance of both regulation and private contracts on credit ratings. It expresses caution, however, about the use of market indicators instead of credit ratings, saying that they can be misleading in times of dislocation.

It believes the credit ratings agencies should produce sovereign ratings more frequently in times of crisis; sovereigns should be notified before publication; the markets should be told if sovereign ratings are unsolicited and how their procedures differ for unsolicited ratings.

With regard to the process of rating sovereign debt the ECB says¹⁰

'The Eurosystem fully supports measures aimed at increasing the disclosure, transparency and clarity of methodologies, models and assumptions parameters surrounding the approach adopted by each CRA.'

The ECB is concerned about the oligopolistic structure of the credit ratings industry and advocates forcing hired credit ratings agencies to share the private information that they obtain from a firm with other credit ratings agencies so that these other agencies could also rate the firm and build a reputation.¹¹

While most of the ECB's suggestions are reasonable, the need to notify sovereigns before the publication of a rating is not. Clearly, the opportunities for corruption would be endless, both in the rating agencies and in the national ministries of finance, if such highly market-sensitive information as an impending rating change were to be provided to the sovereign before it becomes public knowledge!

The European Commission has also proposed suspending ratings when a country is negotiating a programme with the troika (EC, ECB and IMF) or when a country is under a programme. Like the ECB, it proposes that the sovereign be notified before a new rating is published. Both these ideas are ill-conceived, indeed terrible. When a country is negotiating a programme or is on a programme it is likely to be in deep sovereign or external debt trouble and uncertainty is high. This is when investors need information the most if they are to take informed positions and when the value of ratings is greatest. The ECB is right that ratings should be more frequent during such periods.

⁹ For the ECB's opinions, see ECB (2011):

<http://www.ecb.int/pub/pdf/other/ecpublicconsultationcreditratingagencieseurosystemreplyen.pdf>

¹⁰ ECB (2011, p. 5).

¹¹ Perhaps, however, this would induce firms to be less forthcoming with their private information.

4.4 Should the ECB take the role of an independent provider of sovereign risk ratings? Should a new independent European Credit Ratings agency?

The European Commission floated the rather preposterous idea that it might be “useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions.”¹² The ECB is not interested, stating bluntly, “The ECB should not issue public ratings to be used for regulatory purposes.”¹³ The ECB is quite right for two reasons. The first is that the ECB is the entity that was too squeamish to haircut the Greek debt presented to it as collateral. At the Dec 2005 post-policy press conference President Trichet explained:

‘We thought that this was not appropriate. We said that it was not appropriate for us to invent a new sanction that would apply for non-compliance with the Stability and Growth Pact via this collateral mechanism. We felt that we should not do that.’

It is apparent that the ECB would find it difficult to downgrade a Member State’s debt. It cannot be expected to provide ratings that are not politically motivated. In addition, the ECB has been acting as market maker of last resort in sovereign debt markets and as lender of last resort for market-impaired sovereigns since the inception of the Securities Markets Programme in May 2010, and it now owns around EUR 200 billion worth of peripheral euro area sovereign debt outright, in addition to having many hundreds of billions of euro’s worth of exposure to these same sovereigns through sovereign debt offered as collateral to the Eurosystem by banks that are themselves likely to fail should the sovereigns whose debt they offer as collateral fail. The ECB would therefore be clearly conflicted if it had a sovereign debt rating role.

The second reason that the ECB would not be a good provider of sovereign debt ratings is that the transparency that the ECB has called for from providers of sovereign debt raters is not its own strong suit. Most of the world’s major central banks are opaque, but the ECB stands out as possibly the least open and transparent of the lot. We are still waiting to learn about the methodologies, models and assumptions parameters that the ECB uses to determine the theoretical prices for the illiquid marketable securities and the haircuts on collateral that it uses in its lending operations. We are still waiting to hear whether we shall ever find out exactly what securities the Eurosystem has bought under the SMP, from whom it bought these securities and at what prices. The same holds for the securities offered as collateral in its repos and other collateralised transactions, both at the Eurosystem and at the emergency liquidity assistance (ELA) facilities run by the national central banks (NCBs) of an increasing number of euro area Member States.¹⁴

It has been proposed that a new European Credit Ratings agency could be established. The ECB rightly questions the independence of a partially publically funded entity. It also notes the difficulty and expense in setting up such an agency and the long time it would take for the agency to become operative. It also makes the reasonable point that such a semi-public entity might raise the barriers to entry, decreasing competition rather than increasing it.

¹² ECB (2011, p. 12).

¹³ ECB (2011, p. 7).

¹⁴ Although the ELA’s assets are notionally an exposure of the NCBs and of the sovereigns that guarantee this exposure, in practice, with quite a few of the guarantor sovereigns themselves insolvent or at material risk of insolvency, the ELAs’ exposure is likely to revert to the Eurosystem, and ought to be accounted for by the ECB to the European Parliament and the European citizen and tax payer.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Rating Agencies and Sovereign Credit Risk Assessment

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NOTE

Abstract

Credit rating agencies (CRAs) have not consistently met the expectations placed on them by investors and policymakers. It is difficult, however, to improve the quality of ratings through regulatory initiatives. In the short term, changes to the CRAs's regulatory environment, in a context of high market uncertainty, may add to market stress. The role of credit ratings in regulation should be reduced but eliminating it entirely would have significant downsides, at least in the short term. The transfer of ratings responsibility to public authorities, including the European Central Bank, is unlikely to be a good alternative because of inherent conflicts of interest. The notion of risk-free sovereign bonds is challenged by the crisis, but the most straightforward way to address this challenge in the euro area context would be the establishment of a euro-area-wide sovereign bond instrument.

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LIST OF ABBREVIATIONS

BIS	Bank for International Settlements
CDS	Credit Default Swap
CRAs	Credit Rating Agencies
ECB	European Central Bank
ECON	Committee on Economic and Monetary Affairs
EURIX	European Rating Index
FSB	Financial Stability Board
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development

EXECUTIVE SUMMARY

This policy brief provides a critical discussion of credit rating agencies and sovereign credit risk assessment. Credit rating agencies (CRAs) have not consistently met the expectations placed on them by investors and policymakers. This has been most evident in the case of the US sub-prime mortgage ratings but also in the erroneous announcement by Standard & Poor's (S&P) to some of its clients of a downgrade of France.

Credit rating agencies derive some of their importance from the fact that the regulatory system relies on their assessments. Reducing this reliance in the long term is desirable. However, robust alternative assessments of risk will need to be developed. In the short term, frequent changes to the CRAs's regulatory environment, in a context of high market uncertainty, may add to market stress. Moreover, improving the quality of ratings through regulatory initiatives on other fronts may also not be easy.

The transfer of ratings responsibility to public authorities, including the European Central Bank, is not compelling because of inherent conflicts of interest. Even more worryingly, a rating given by such a public authority may undermine the trust in the authority in case of errors of judgment which cannot be securely ruled out. Creating a completely separate public CRA may also not be desirable as it is unlikely to be perceived as free from conflicts of interest, in particular when rating sovereigns.

The notion of risk-free sovereign bonds is challenged by the crisis. The most straightforward way to address this challenge in the euro area context would be the establishment of a euro-area-wide sovereign bond instrument. Clearly a large part of current sovereign bond market volatility results from conflicting political signals as regards the further treatment of the sovereign debt of euro area member states.

BACKGROUND AND AIM

Sovereign credit ratings have been in the spotlight since the start of the European sovereign debt crisis, and have received considerable attention from both the media and the political community. The European Union has been an active legislator on ratings with the adoption of the first (November 2009) and second (May 2011) Regulations on Credit Rating Agencies, and proposals for a third published by the European Commission in November 2011. The European Parliament has been an active participant in this process, including the adoption in March 2011 of a Report on Credit Rating Agencies (2010/2302(INI)) by its Committee on Economic and Monetary Affairs (ECON).

This note attempts to clarify key policy questions related to sovereign credit ratings. It leaves aside broader policy challenges posed by credit rating agencies which are not specifically related to the sovereign credit segment. These have been reviewed in a separate Bruegel publication (Véron, 2011).

1. THE IMPACT OF SOVEREIGN CREDIT RATINGS ON THE SOVEREIGN BOND MARKETS

Credit rating agencies have been repeatedly blamed for causing or exacerbating negative market developments in the context of the European sovereign debt crisis¹. Some recent developments, in particular the erroneous announcement by Standard & Poor's (S&P) to some of its clients of a downgrade of France, have added to volatility.

However, the question of the extent to which credit ratings exacerbate fluctuations in sovereign credit markets is far from trivial. Consensus on sovereign bond markets often evolves faster than credit ratings, which tend to typically be "behind the curve". Negative ratings decisions are often made after the deterioration of market-based credit indicators. This has been a consistent pattern since the start of the financial crisis. In that sense, ratings can be considered as lagging indicator that often show only information that is already known by the market.

When negative ratings decisions are made, they are unsurprisingly generally associated with yield increases (an outlier was the downgrade of the United States by S&P in early August 2011, which was associated with a general increase in risk aversion and lower yields on US bonds because of their safe-haven status). This effect is confirmed by recent studies such as those published by the International Monetary Fund (Arezki, Candelon & Sy, 2011) or the European Central Bank (Afonso, Furceri & Gomes, 2011). However, the extent of this impact is less clear. In particular, the ECB study notes that negative ratings decisions tend to be preceded by negative market developments, raising questions about the direction of causality. Consistent with previous literature, the ECB paper confirms the existence of a significant reaction, on the part of both sovereign yields and CDS spreads, to rating announcements (this is true in particular for negative events). The analysis goes a step further since it assesses if both sovereign yields and CDS spreads had already absorbed the information contained in changes to ratings before their announcement. As regards the anticipation mechanism, the main result is that the information contained in rating announcements is not anticipated by the credit market while the CDS market seems to anticipate the information contained in rating downgrades. The ECB study specifically investigated the issue of causality between ratings changes and yields/CDS spread over the short-term and concluded that there is "two-way causality between sovereign credit ratings and government bond yield spreads", namely that "past values of changes in yield (CDS) spreads are significant determinants of the change in effective rating and vice-versa" (Afonso, Furceri & Gomes, 2011).

Furthermore, this is not a static picture as investors' behaviour changes over time. Anecdotal evidence suggests a gradually reduced dependence on credit ratings since the start of the euro-area crisis. For example, some large investors appear to have moved away from relying on ratings-based sovereign-bond benchmarks indices to form their own benchmarks with no reliance on ratings. Strikingly, some negative ratings decisions during the past 18 months have had negligible market impact, suggesting that many commentators' emphasis on "mechanical effects" does not capture the complexity of linkages. It is to be noted, in particular, that the above mentioned IMF and ECB analyses are based on data series stopping in May and October 2010 respectively, and therefore do not include observations of the latest 12 months of the crisis. This is significant as,

¹ See, for example, Nowotny, July 2011, "It is all apparent from public statistics and whether these statistics are accurate or not, the rating agencies... do not give any more intrinsic knowledge, they simply give opinion. And these opinions, they continue to give them in such a way that it worsens the crisis"(available at <http://in.reuters.com/article/2011/07/12/ecb-nowotny-idINLDE76B1Q320110712>).

especially after the G20 Deauville declaration of 18 October 2010, market developments appeared to be driven more by political pronouncements and less by ratings decisions. The Bank for International Settlements has concluded that the Deauville declaration had significant market impact (BIS, 2010).

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2. REDUCING OVER-RELIANCE ON CREDIT RATINGS

Credit rating agencies derive some of their importance from the fact that the regulatory system relies on their assessments. This reliance is observed in bank regulation, which in some circumstances sets banks' capital requirements in relation to asset risks as assessed by CRAs. Similar regulations exist for insurance and other financial market participants. Following the failures of ratings in the US sub-prime mortgage-based securities market, significant work has been undertaken by regulators and supervisors, at the global level and on both sides of the Atlantic, to reduce regulatory reliance on credit ratings. The most radical initiative so far has been the decision by the US Congress to ask federal supervisors to eliminate all references to credit ratings in their rules (Section 939A of the US Dodd-Frank Act of July 2010). However, implementing this decision is proving difficult, not least because it impedes the adoption by the US of global supervisory standards ("Basel 2.5" and Basel III) which do refer to credit ratings². At the global level, a review of this issue by the Financial Stability Board has concluded that "in certain cases, it may take a number of years for market participants to develop enhanced risk management capability so as to enable reduced reliance on credit rating agencies" (FSB, 2010).

One problem is that, while references to risk ratings in regulations are indeed undesirable, the alternatives might be even worse. In particular, banks' own models of risk assessment have been proven in the crisis to be even less reliable than credit ratings, including in the largest banks where risk management was widely believed to be most advanced (see for example UBS, 2008). Replacing references to ratings with references to market-based risk indicators may sharply increase pro-cyclicality, as such indicators are typically much more volatile than credit ratings (see for example Moody's, 2009, in the case of corporate ratings).

As a consequence, it is to be expected that ratings will be complemented with other measures of risk, but that a complete elimination of references to credit ratings from the European financial rulebook would appear both impractical and undesirable given the lack of proper alternatives in many cases. Moreover, contemplating such steps in the current period of market stress may contribute to short-term volatility.

In particular, the EU and its member states should proceed with full implementation of the "Basel 2.5" and Basel III accords, including the extent to which these still refer to the use of credit ratings in spite of the Basel Committee's efforts to reduce reliance. These efforts by the Basel Committee and other international financial standards-setters are expected to continue and to bring gradual improvements in the years to come. Opting for a complete elimination of any regulatory reference to credit ratings in the short term would have significant downsides.

² Westlake M. (2011), "Dodd-Frank stalls US move to Basel trading book rules", Global Risk Regulator, September .

3. A EUROPEAN RATING FOUNDATION

In a resolution adopted in June 2011, the European Parliament asked the European Commission to study the creation of a new fully-independent European Credit Rating Foundation (European Parliament, 2011). The resolution does not include an explicit deadline for this. The Commission's proposal for a third EU Regulation of CRAs (CRA3) does not retain the option of EU-level public sponsorship of a new CRA: "This proposal is not aimed at setting up a European credit rating agency. As requested by the European Parliament in its report on credit rating agencies of 8 June 2011, this option was assessed in detail in the impact assessment accompanying this proposal. The impact assessment found that even if a publicly funded CRA may have some benefits it terms of increasing the diversity of opinions in the rating market and providing an alternative to the issuer pays model, it would be difficult to address concerns relating to conflicts of interest and its credibility, especially if such CRA would rate sovereign debt. However, these findings should by no means discourage other actors from setting up new credit rating agencies. The Commission will monitor to what extent new private entrants in the credit rating market will provide for more diversity" (European Commission, 2011). In June, the Parliament also proposed to establish a European rating index (EURIX), incorporating all ratings of registered CRAs that are available on the market (European Parliament, 2011).

Indeed, while more competition in the credit ratings market is desirable, it is not clear that this can be achieved through a public initiative. A publicly-sponsored ratings agency would be assumed by market participants to be politically constrained in its credit assessments and would therefore struggle to make a difference in terms of market perceptions – especially in a context in which there is a widespread perception that EU authorities are tempted to increase political leverage over ratings decisions generally, as illustrated by the debate on the preparation of the CRA 3 Regulation before the publication of the European Commission's proposal in mid-November 2011.

Incidentally, it is not clear that a specialisation in sovereign ratings could represent a sustainable business model for a financially independent ratings agency. Sovereign ratings by the three most established CRAs do not generate significant revenue³. CRAs rate the largest sovereigns not as a direct revenue generator, but because it is a necessary building block for other, more lucrative ratings segments such as those of corporate issuers. Indeed, many sovereign ratings are unsolicited, especially for the largest sovereign issuers, and as a consequence they are a pure cost centre for the CRAs. The low financial dependence on sovereign ratings also results in less obvious conflicts of interest in rating sovereigns than in other segments of CRA activity.

³ No public figures are available but anecdotal evidence suggests that revenue generated by sovereign ratings is no more than a few percent at most of the leading ratings agencies' total revenue.

4. ASSUMPTION OF AN EXPLICIT RATING ROLE BY PUBLIC AUTHORITIES

If a public authority such as the ECB or the IMF were to publish sovereign credit ratings, it is likely that they would be considered by market investors very differently from those assigned by private-sector CRAs, if only because both institutions are at least potentially able to directly impact sovereign creditworthiness with their own policy decisions, and because sovereigns participate in both institutions' governance. According to a report from the House of Lords, the IMF (or OECD) cannot avoid conflicts of interests by acting as rating agency because it is involved in providing money to the EU and because its constituencies and effective owners are the governments themselves (House of Lords, 2011). In addition, the IMF's or ECB's credibility would suffer if their ratings were to be seen as inadequate following developments happening after their publication.

One specific issue that has been in the spotlight in recent months is the ECB's collateral policy, which has required successive revisions as the sovereign ratings of euro-area countries, in particular Greece, have been downgraded. The consequence has been that the ECB's criteria for the acceptance of collateral have been much less reliant on credit ratings in practice than they had appeared to be in principle. An influential paper by Buiter and Sibert (2005) has even gone as far as to argue that the ECB's own collateral policy for its repo operations has contributed to some of the fiscal indiscipline observed before the crisis because it insufficiently discriminates between euro-area sovereign bonds.

A related issue is the risk-weighting of euro-area sovereign debt in banks' capital calculations, for which the current zero risk-weighting under the applicable Capital Requirements Directives appears increasingly at odds with financial reality. The Deputy Director-General of the Bank for International Settlements, the Chairman of the European Banking Authority, and the Chair of the ECON Committee have all been reported as advocating a reexamination of the zero risk-weighting policy⁴. However, this specifically applies to the euro area as a unique currency union of large developed economies. The fundamental question is not so much the distortions induced by the zero risk-weighting, but the absence of an effective risk-free asset in the euro-area financial construct, which one might relate to the broader current debate on the design flaws of the euro-area fiscal framework. Particularly given current market instability it may therefore be too early to envisage a root-and-branch reform of the principles that underpin sovereign credit risk-weighting in capital regulation, at least as long as the outline of the euro area's future fiscal policy framework remains undetermined (see Tett, 2011, for a broader exposition of this argument).

⁴ See Hickley A. (2011), "MEPs plan revolt on 0% sovereign risk", GFS News, 21 October; and York N. (2011), "BIS blasts EU on 0% sovereign risk", GFS News, 27 October

CONCLUSIONS

Credit rating agencies (CRAs) have not consistently met the expectations placed on them by investors and policymakers. It is difficult, however, to improve the quality of ratings through regulatory initiatives. In the sovereign bond market, CRAs often follow a general deterioration in market sentiment. At the same time, major announcements have also added to market pressure so that a two-way causality has been established. Ratings decisions on sovereigns have a market impact because the financial system partly relies on ratings for risk assessment and balance sheet composition. However, reducing the regulatory reliance on ratings is not an easy task. The more fundamental question that the euro area needs to solve are what a safe euro-area-wide reference asset would look like, given that national sovereign bond are ever less able to play this role, and how it could be constructed.

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Ratings Agency Reform: Shooting the Messengers?

Karl WHELAN

NOTE

Abstract

The European Commission has produced a wide-ranging package of proposals aimed at reforming the way credit ratings are issued and used. The Commission's concerns about "hard wiring" of credit ratings into the operation of the financial system are well-founded but there are limits and pitfalls to the alternatives that they propose. The proposals on sovereign debt are largely unobjectionable but the idea that ESMA needs to approve credit risk methodologies is worrying in light of the wholly unreasonable criticisms of sovereign downgrades from elite European policy makers. Proposals to increase competition via issuers rotating their ratings providers are unlikely to do much to improve the quality of ratings unless the current issuer-pays model is changed. A more radical reform, involving a move towards an investor-pays model, needs to be considered.

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1. INTRODUCTION

After the global financial crisis triggered by widespread losses on supposedly low risk AAA-rated structured finance products, enthusiastic supporters of the world's major credit ratings agencies are hard to find.

By even the most basic microeconomic criteria, the structure of the industry is hardly ideal, with the vast majority of ratings provided by the two largest incumbents. Furthermore, their funding model, in which almost all the fees are collected from those who issue securities rather than those who buy them, leaves the agencies wide open to accusations of systematic mis-rating of products in order to generate revenue.

In light of these problems, it is hardly surprising that the European Union has decided to formally regulate the credit ratings agencies via the European Securities and Markets Authority (ESMA). The European Commission has now put forward a new, more extensive, package of proposals which would change the way that ratings are used and provided.¹

As is often the case with these packages, they are mixture of good, bad and indifferent. Among the more substantive proposals, the good and indifferent are the following:

- The proposals to reduce the so-called “hard wiring” dependence of financial institutions, regulators and central banks on agency ratings are in line with previous recommendations from the Financial Stability Board and other agencies. However, the key inappropriate hard wiring that the EU is responsible for—the zero risk-weight that Euro area banks can apply to European sovereign debt—remains in place.
- Proposals to reduce the reliance of institutions on agency ratings and replace them with internal risk models are well-intentioned but seem to underestimate the problems associated with the development of in-house risk models as well as their oversight by financial supervisors.
- Proposals to boost competition, via requirements that issuers rotate the agencies that rate their securities, may make some limited progress towards the intended goal of increased competition. Whether this would lead to higher quality regulations is an open question.

The bad aspects of the package, and the political hype that has surrounded it, relates to sovereign ratings. Despite the widespread acceptance that the agencies mislead investors by underestimating the credit risk associated with structured finance problems, the political discussions surrounding the proposed reforms have focused extensively on the idea that the agencies are being too harsh in their assessments of Euro area sovereign risks. This is despite the clear risks associated with high debt levels, troubled banks, rising sovereign yields and the precedent for private sector involvement set by the Greek situation.

I believe the reaction of the European policy elite to sovereign downgrades, complete with dark murmurings about financial market plots against the euro and the need to have a European agency to provide to rate sovereign debt, has been little short of hysterical messenger shooting.

¹ The full package of Commission proposals as well as explanatory documents are available at http://ec.europa.eu/internal_market/securities/agencies/index_en.htm.

In light of this background, I am concerned that the Commission's proposals for ESMA to "verify that methodologies and changes to methodologies comply with regulatory requirements" could prove to be a vehicle through which European politicians can put pressure upon officials to decide that methodologies pointing to ratings downgrades be discarded.

In the rest of this paper, I will first discuss the proposals to reduce institutional dependence on agency ratings and then move on to the more delicate problem of sovereign debt ratings. I will conclude by discussing the proposals aimed at reforming the structure of the credit ratings business.

2. REDUCING DEPENDENCE ON RATINGS

2.1 The Role of Ratings in Financial Markets

The role of ratings agencies in financial markets has evolved considerably over time. The agencies started out as relatively small companies offering their opinions to investors on the credit quality of borrowers. However, as debt markets grew in size and complexity, the agencies became a more systemically important part of the financial system.

Over time, it became common for ratings to be written into contracts for repurchase agreements and derivatives and into the investment mandates of pension funds and life insurance companies. In addition, regulators have given quasi-official recognition to the role of ratings agencies starting with the introduction of the idea of Nationally Recognized Statistical Rating Organisations in the US. Agency ratings began to play a role in many different aspects of regulation from lower reporting requirements for highly-rated firms when issuing bonds to the requirement that money market mutual funds buy only highly-rated debt and, finally, to the recognition that agency ratings could be used in the computation of regulatory capital requirements for commercial banks as part of the Basel II agreement.

There are a number of dangerous aspects to this institutional dependence of financial markets on agency ratings. One problem is that the reliance on agencies has the effect of reducing the amount of monitoring done by holders of debt instruments. If agencies rate a bond AAA then those who run a fund can argue that there is little point in them allocating valuable resources doing an independent assessment of a bond that has already been given a quasi-official seal of approval. This can lead to a general reduction in the quality of the financial system's assessment of risks and there is little doubt that this occurred with the widespread lack of questioning of the quality of structured finance assets during the middle of the last decade.

A second problem created by institutional dependence on ratings is the so-called "cliff effect" that occurs when agencies downgrade widely-held financial instruments. The downgrade can lead to sales of these assets by funds with restrictions on their investment mandates, banks concerned about regulatory capital ratios and institutions using these instruments as collateral in repo agreements. This can trigger sharp declines in the value of the downgraded instruments which can increase financial market volatility and perhaps threaten the solvency of those institutions holding these bonds. A world in which firms undertook their own credit assessments, which would change at different times rather than all at once, would be less subject to this source of instability.

2.2 Proposals to Reduce Dependence

The Commission's assessment that there is too much reliance on agency ratings by financial institutions and regulators mirrors the previous assessment of the Financial Stability Board and other international agencies.² The key Commission proposal in relation to reducing this reliance is a new directive which

"requires certain financial institutions to make their own credit risk assessment. They should therefore avoid relying solely or mechanistically on external credit ratings for assessing the creditworthiness of assets."

Specifically, the Commission proposes that financial institutions should develop internal rating models for use alongside or in place of agency ratings. The Commission's Impact Assessment of these proposals states that

"the development and use of internal rating models would enhance the capacity for internal credit assessment of firms with material and complex credit risk exposures ... The internal rating models would contribute to ensuring that credit risks are adequately managed."

The proposals rely on regulatory supervision to ensure that this approach works well is not simply gamed by banks looking to generate extra profits through higher leverage. Specifically, the proposals recommend that

"Competent authorities should supervise the adequacy of these financial firms' credit assessment processes including monitoring that financial firms do not over-rely on credit ratings."

I think there are good reasons to encourage financial institutions to reduce their mechanical reliance on agency ratings. However, even with the various official acknowledgements of the potential problems with internal models, I think the Commission is over-estimating the gains from increased usage of internal models.

While the past mistakes of ratings agencies are well known, it still must be acknowledged that credit risk assessment is a complex business. Most institutions will not have anywhere near the resources to devote to credit risk analysis of individual securities that the ratings agencies do. One likely outcome will be that institutions will often outsource the provision of credit ratings to professional firms who can provide standardised risk assessment models, such as the well-known RiskMetrics approach. If the majority of firms are using the same modelling approach and this approach proves to be mistaken, the implications are likely to be similar to the effects of taking advice on the basis of overly optimistic agency ratings.

Reinforcing this tendency for a lack of diversity in risk assessment will be the fact that regulatory agencies are unlikely to be able to put large numbers of supervisors to work assessing a wide range of different risk models adopted by the financial institutions they regulate. The experience with internal ratings based models in the implementation of Basle II is instructive, though there is little reference to it in the Commission's materials.

When the use of internal ratings based models was introduced into the Basle II agreement, it was accepted that it would not be feasible for supervisors to evaluate a wide range of different types of credit risk models. For this reason, to be allowed use internal models for regulatory purposes, banks needed to adopt the Value-at-Risk-style model specified in the Basle Committee's 2005 document "An Explanatory Note on the Basel II IRB Risk Weight Functions". If this precedent is followed, then it is unlikely that dispensing with the use of agency ratings will result in the variety of internal risk assessments that the Commission is hoping for.

² See, for instance, Financial Stability Board (2010).

Furthermore, even if a common internal risk assessment model is settled on, there are a number of difficulties for supervisors when assessing whether these models are adequately implemented. Philipp Hildebrand of the Swiss National Bank provided a useful discussion of these issues in a 2008 speech at the LSE. He pointed out that:

"the increased reliance on banks' internal models has rendered the job of supervisors extraordinarily difficult. First, supervisors have to examine banks' exposures. Second, they have to evaluate highly complex models. Third, they have to gauge the quality of the data that goes into the computation of these models. To put it diplomatically, this constitutes a formidable task for outsiders with limited resources."

Overall, my assessment is that while the proposals to reduce regulatory reliance on ratings agencies are welcome, the gains from improved risk management from the proposed alternative approach are likely to be fairly small.

2.3 Zero Sovereign Risk Weights and ECB Collateral Rules

While the Commission's assessment that agency ratings are inappropriately "hard-wired" into the financial system is undoubtedly correct, it is worth noting that the focus on the use of ratings fails to address what is probably the most inappropriate hard-wiring in the European financial system, which is the regulatory treatment of sovereign debt held by banks.

The Basle II regulations on the use of the "standardised approach" (i.e. the calculation of regulatory capital without use of internal models) are skewed to incentivise banks to hold sovereign debt over corporate debt because sovereign bonds are assigned a lower risk weight than corporate bonds with the same ratings. For example, sovereign bonds rated AAA to AA- receive a zero risk weight, while corporate bonds with the same rating receive a 20 percent weight; sovereign bonds rated A+ to A- receive a 20 percent risk weight, while corporate bonds with the same rating receive a 50 percent weight.³

The European Union, however, in its implementation of Basle II went well beyond these Basle Committee's guidelines in favouring sovereign debt holdings. The CRD Directive (2006/48/EC) that implements regulatory capital requirements in the European Union states that⁴

"Exposures to Member States' central governments and central banks denominated and funded in the domestic currency of that central government and central bank shall be assigned a risk weight of 0 %."

This approach meant that European banks could consider Greek debt (rated A- in 2009 even before the crisis unfolded) to have the same risk level as German debt when calculating regulatory risk requirements. The failure of stated levels of regulatory capital (measured relative to risk weighted assets) to accurately reflect the risk associated with sovereign bond holdings has been a continued source of scepticism from international markets when assessing the health of European banks. This particular piece of hard wiring needs to be removed.

³ See Basle Committee on Banking Supervision (2006).

⁴ eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF

It is also likely that this regulation played a role in the general lack of market discipline in relation to lower quality Euro area sovereign debt prior to the crisis. Taking on lower-rated but high-yielding sovereign debt thus became a cost-free way to increase leverage and the return on equity. Admittedly, this increased return comes at the cost of increased credit risk but this is a risk many bankers are willing to take given the pressure they are under to deliver high returns.

The incentive to bet on risky European sovereign debt was exacerbated by the European Central Bank's willingness to accept all Euro area sovereign debt as collateral, allowing for a form of "carry trade" in which low cost central bank funding was channelled towards purchasing higher yielding sovereign debt.

Of course, recent events have shown that the ECB's collateral rules are an exception to the "hard wiring" of agency ratings into the banking system. The Eurosystem Credit Assessment Framework (ECAAF) for deciding on the eligibility of collateral has, in fact, never relied in a mechanical fashion on credit agency ratings.⁵ Rather, the Eurosystem has utilised various sources of information in addition to agency ratings, including the judgment of a number of national central banks that operate their own in-house credit assessment systems.

That said, the stated intention of the ECB's collateral rules is to only accept collateral with "high credit standards" and it is hard to reconcile this intention with a policy of accepting bonds rated at junk status by the ratings agencies. The ECB has decided, however, in the case of Greece, Ireland and Portugal to continue accepting junk-rated sovereigns as collateral.

I don't wish to criticise these decisions. I do believe, however, that the rationale underlying them should be explained and the Eurosystem collateral guidelines refined as a result of the explanation. As best I can tell, the current preferred argument of ECB officials in relation to these decisions is that they are still only accepting high quality assets and that the ratings agencies are incorrect about the credit risk on peripheral debt.

I think this is a poor argument. The credit risk on this debt is very real. A better explanation is that the ECB needs to maintain financial stability in the Euro area as part of its mandate to maintain price stability and support the other economic goals of the Union. The removal of the ability to use sovereign-backed collateral for ECB financing for banks from these three countries would have had disastrous effects on the European financial system. For this reason, occasional deviations from standard collateral rules are sometimes required. Such a "financial stability" exception should be provided for in the official guidelines on eligible collateral.

In the future, however, the ECB should work to limit the exposure of Euro area banks to the sovereign debt of their own country. Such investments are a poor risk hedge and, given the precedents set by the ECB's decision to continue accepting junk-rated collateral, it can't be denied that banks loading up on their own country's sovereign debt represents a source of financial risk to all Euro area countries.

⁵ See Chapter 6 of ECB (2011).

3. SOVEREIGN BOND RATINGS

3.1 Political Controversy Over Sovereign Ratings

Given the well-known incentive problems associated with the issuer-pays model, there is a general agreement that credit ratings agencies tend to be positively biased in their assessments of credit risks. However, over the past year, it has become clear that many senior European politicians and bureaucrats believe that the agencies are being far too negative in their assessment of the risks associated with Euro area sovereign debt.

A brief but representative sample can help provide a general idea of the thinking of the European policy elite.

- Jean-Claude Juncker, Luxembourg's prime minister and chairman of the Eurogroup of finance ministers, speaking in July after Portugal had been downgraded, said that rating agencies "are taking steps that do appear to those of us who are involved in the solution [to] these problems to be irrational and unreasonable." He also said the rating companies' influence is a "disastrous one" because downgrades might discourage governments from taking further reform steps. "So I'm calling them to a more responsible behavior".⁶ Juncker called for setting up a European ratings agency, presumably in the expectation that it would provide higher ratings.⁷
- Also speaking in July after Portugal's downgrade, European Commission President Manuel Barroso is reported to have said the decision was unhelpful and unnecessary, and would only provoke more market speculation against the euro, adding: "I think our institutions know Portugal a little bit better: our analysis is more refined and complete." A spokesperson for Barroso said about a similar decision on Ireland: "The decision to downgrade Ireland's credit rating is, in the president's view and the commission's view, incomprehensible. Its timing, as the second quarterly review mission is preparing to announce its findings, is, to say the least, questionable."⁸
- Austrian Central Bank Governor Ewald Nowotny has questioned whether there is any useful informational content in credit agency sovereign ratings. "It is all apparent from public statistics and whether these statistics are accurate or not, the rating agencies ... do not give any more intrinsic knowledge, they simply give opinion ... And these opinions, they continue to give them in such a way that it worsens the crisis."⁹
- ECB officials regularly get in on the agency-bashing act. Executive Board member Lorenzo Bini-Smaghi had criticised the agencies as losing credibility by paying attention to bond market yields saying "Some of [their ratings] revisions were not based on macro-economic data or new budgets, but on the assessments given by the market for sovereign bonds and the possibility of ... In this way the agencies have not given an independent assessment, but one linked to the market's reaction."¹⁰ Fellow Executive Board member Juergen Stark has also criticised what he calls "the pro-cyclical behaviour of rating agencies which in my view is really irresponsible" and has said that "For a long period of time (the question has been) what do rating agencies know more."¹¹

⁶ www.bloomberg.com/news/2011-07-07/juncker-urges-more-efforts-to-create-european-rating-agency-1-.html.

⁷ online.wsj.com/article/BT-CO-20110707-709180.html.

⁸ www.huffingtonpost.co.uk/2011/07/13/irish-bonds-junk-status-s_n_897498.html.

⁹ www.reuters.com/article/2011/07/12/us-ecb-nowotny-idUSTRE76B6QU20110712.

¹⁰ <http://blogs.wsj.com/economics/2010/05/13/ecb-official-lashes-out-at-rating-agencies/>

¹¹ <http://www.reuters.com/article/2010/06/11/ecb-stark-idUSLDE65A0HX20100611>.

My opinion is that these views represent a combination of shooting the messenger and failing to understand the meaning of the message. I would like to make three points on this topic.

1. How Sovereign Defaults Happen

Consider the criticism that the ratings agencies should not take fluctuations in bond market yields into account. I believe this criticism fails to understand the nature of sovereign credit risk.

In many ways, sovereigns are like illiquid banks that rely on the confidence of their creditors to keep operating. Their reputation as good credits relies on their ability to tax their citizens (and perhaps on their ability to print money via their control of their central banks). However, at any point in time, most government revenue is pre-allocated to various spending programmes and there are usually severe political limits on the size of tax increases and spending cuts that can be implemented at any point in time. This means that even governments that are not running deficits are reliant on the confidence of the bond market to continue rolling over their existing debts, while those running deficits are even more reliant on bond market sentiment.

Complaints that ratings seem to be coming thick and fast and that these downgrades cannot reflect underlying fiscal soundness underestimate the complex “non-linear dynamics” of sovereign debt default. A perceived one percent risk of default will add a little to a country’s cost of funding but can be dealt with fairly easily. However, a perceived five percent risk of default will likely raise the cost of funding to the point where the cost of servicing the debt gives rise to fears about debt sustainability. Above these low levels of perceived default risk, the probability of default moves very quickly towards one. A sovereign can go from being perceived as a low risk to outright default in a short amount of time if it is hit with a sufficiently bad set of events.¹²

Sovereign defaults in prosperous European countries will not occur because the politicians in these countries actively decide to default on their debts. They occur because there is a “buyers strike” and the country fails to roll over its debt. The failure to pay out on one tranche of bonds then triggers repayment demands on other bonds and the result is a full-scale debt restructuring, which usually involves significant losses for creditors.

It is this credit risk that the agencies are measuring. Standard and Poor’s, for instance, state that their “credit ratings express the agency’s opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time” while Moody’s ratings are largely based on their assessment of expected loss.¹³

Given that worsening investor sentiment and a buyers strike is the principal source of a sovereign being unable to meet obligations, the agencies would be in completely failing to do their job if they simply ignored the signals available from bond market yields. Indeed, despite the constant drumbeat of criticisms from European officials, the agencies have generally been slow to react to worsening market conditions. In most cases, European sovereigns have already had secondary market bond yields equivalent to more poorly rated credits for some time before the agencies have downgraded.

¹² See Flood and Marion (2009) for a nice discussion of the analytics of how a debt default can come about quickly.

¹³ See http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us#def_1 and <http://www.moodys.com/sites/products/AboutMoodyRatingsAttachments/2000400000300541.pdf> for documentation.

2. Informal Content

European officials argue that the ratings agencies should simply look at the data on debt and deficits as well as the proposed adjustment programmes. It is unclear why they think this should produce a better assessment than the agencies are currently providing.

The European countries rated poorly by the agencies have either high debt burdens by historical standards (Greece, Ireland, Italy, Belgium) or banking systems suspected to contain large losses (Spain) or extremely poor long-term growth performance (Portugal). In relation to planned adjustment programmes, the austerity programmes in Greece, Portugal and Ireland have generally been associated with ongoing recession which makes stabilisation of the public finances very difficult. So an objective examination of the data and adjustment programmes is hardly grounds for rating all these countries highly.

The idea that agency staff don't know any more than one can glean from looking at official data and policy documents is also unfair. Agency staff rating sovereign debt visit countries and speak with government officials as well as taking soundings from private citizens. (I have met staff from agencies on their visits to Ireland on a number of occasions and have always found them to be well-informed.) Investors have every reason to expect the agencies to do more due diligence than simply sitting in their office reading statistics and, as far as I can tell, this is certainly happening in relation to Euro area sovereigns.

It is also worth remembering that Euro area member states with poor finances also no longer have access to their own central bank as a source of funding for their deficits. While one can object to monetary financing from a social perspective on the grounds that it simply generates inflation, it has the advantage of preventing a "sudden stop" leading to default. And while investors may get repaid in a devalued currency, debt monetisation means the loss is shared with the general public who suffer from higher inflation. That the UK, with a high debt ratio and a very high deficit ratio currently has far lower yields than any of the high deficit Euro area countries shows the weight that sovereign debt investors place on having your own central bank.

Judged relative to sovereigns in many other parts of the world, the objective debt situations of many Euro area countries are consistent with the warnings implicit in the ratings provided by the agencies.

3. Adjustment Programmes and Private Sector Involvement

The agencies are providing information to private investors. Those European officials who criticise the agencies should also be aware that the template they have designed for Euro area countries in difficulty is one that is not at all friendly to these investors.

The European reaction to buyer strikes in Greece, Ireland and Portugal has been to step in and provide official funding in conjunction with the IMF. The October 26 agreement on Greece sets a template for how debt sustainability problems in these countries are solved if they cannot return to the bond market. The IMF, as is the tradition, does not take a loss. The EFSF, despite not being a preferred creditor, also does not take a loss. And the ECB does not take a loss on its holdings acquired in the Securities Market Programme.

This leaves private creditors to take all the losses. With high debt burdens and a precedent for private sector involvement, it is only appropriate that the credit ratings agencies are warning investors about the potential losses associated with default scenarios.

3.2 Suggested Changes on Sovereign Ratings

Set against the ranting of European politicians, the actual proposals from the Commission in relation to sovereign debt ratings are pretty sensible.

Various changes are proposed that may take some of the heat out of the controversy over sovereign ratings, such as the proposals that sovereign ratings only be published after the close of business and at least one hour before the opening of trading in the EU and that they inform issuers at least a full working day before publication. Other proposals, such as the requirement to assess sovereign ratings more frequently (every six months instead of every twelve months) and the requirement that agencies release information on the allocation of staff to the ratings of different asset classes (i.e. corporate, structured finance, sovereign ratings) are also perfectly reasonable. However, the gains from these proposals will be limited.

Where I have more concern is with the proposals that ESMA have a role in approving the methodologies applied by the agencies. To quote the Executive Summary:

"Articles 8(5a), 8(6)(aa) and 22a(3) ... require the consultation of stakeholders on the new methodologies or the proposed changes and on their justification. CRAs should furthermore submit the proposed methodologies to ESMA for the assessment of their compliance with existing requirements. The new methodologies may only be used once they have been approved by ESMA. The rules also require the publication of the new methodologies together with a detailed explanation."

I have one serious concern about this recommendation. Given the well-aided opinion of European politicians and senior ECB officials that ratings agencies should not respond to bond market movements, I am concerned that ESMA officials will be negatively disposed towards methodologies that depend on this source of information. Given the importance of investor sentiment in affecting sovereign default risk, I think such an approach could do severe damage to the usefulness of agency ratings.

Finally in relation to sovereign ratings, one proposal that featured in the consultation document but which is not part of the current package is the idea of suspending sovereign credit ratings "in situations where the objectivity and quality of sovereign ratings can be impaired by upcoming market developments." This is a really bad idea. What implicit rating do the European authorities imagine an investor will attach to a bond that was rated BBB and for whom ratings are now suspended? Not BBB, that's for sure.

4. REFORMING THE STRUCTURE OF THE CRA INDUSTRY

The Commission's package also contains a series of proposals aimed at reforming the credit ratings industry in Europe and provides material additional discussing the possibility of more substantial changes at some later point.

4.1 Proposed Rotation Rule

There can be little doubt that the ratings industry exhibits a pretty low level of competition, with S&P and Moody's providing the vast majority of ratings.¹⁴ To address this lack of competition, the Commission is proposing a series of rules that involve issuers having to "rotate" between various ratings providers. According to these regulations

"The CRA engaged should not be in place for more than 3 years or for more than a year if it rates more than ten consecutive rated debt instruments of the issuer. However, this latter rule shall not lead to shortening the permitted period of engagement to less than a year. Where the issuer solicits more than one rating for itself or for its instrument, be it because of a legal obligation to do so or voluntarily, only one of the agencies has to rotate. However, the maximum duration for each of these CRAs is fixed at a period of six years."

I'll restrict my comments on these proposals to two observations.

First, I am not sure that Commission's diagnosis of the source of competition problems is correct. The proposal appears to be based on the assumption that the lack of competition in the ratings industry stems from the existence of long-standing "cosy" relations between issuers and their raters, in which issuers have become used to Moody's and/or S&P and the agencies are happy to provide good ratings as long as they continue to get business from the issuers.

There may be some truth to this but I don't think the idea of cosy relationships really explains the limited competition in this market. The technical barriers to entry into this industry are not so high (it is not so difficult to put together a team of financial experts to do this kind of analysis) so it's not clear from this explanation why there aren't ten different firms each with established long-term cosy relationships with issuers.

Instead, the literature on the credit ratings industry suggests that the implicit barriers to entry associated with reputational issues are considerable.¹⁵ As Hill (2011) discusses, one can find many examples of financial industry specialists who claim that they felt they "had to get Moody's and S&P to rate their securities" because investors would be suspicious if they chose to provide ratings by other less well-known agencies. With this reputational advantage, it has been difficult for newcomers to take a lot of business away from the incumbents.

I suspect that these rules will see a lot of businesses rotating between being rated by Moody's to being rated by S&P, with occasional periods in which a solicited rating means it is being rated by both of the main agencies. The effects in encouraging the growth of new agencies may be limited.

Second, while in most market settings more competition generally produces better outcomes for society, it is not clear that more competition in the credit ratings industry is an example of this general rule, at least not under the current issuer-pays model. Camanho, Deb and Liu (2009) is a well-reasoned paper that illustrates that ratings are even more likely to be inflated if more competitors are introduced into an issuer-pays ratings market. The tendencies of issuers to "shop" for ratings and for raters to look to

¹⁴ Deb et al (2011) provide an excellent review of the current state of the ratings industry.

¹⁵ See Mathis, McAndrews and Rochet (2009) and Deb et al (2011).

keep business by offering a positive credit assessment are greater when there is more competition.

On balance, while I don't have any great objections to these rules. I'm not sure they will create more competition and, if they do, whether this will provide us with higher quality ratings.

4.2 More Radical Reforms?

The Commission's consultation document in relation to these proposals put forward some ideas for more radical changes to the rating agency industry.

One of the proposed ideas was to entrust the ECB or national central banks with the job of issuing ratings to be used for regulatory purposes. An alternative idea is that the European Commission, which is already involved in fiscal policy assessment should provide sovereign ratings. I don't think either of these suggestions are good ones.

- The ECB has proven itself to be a very poor judge of sovereign default risk via its behaviour during the Greek crisis. ECB officials, from Jean-Claude Trichet on down, repeated the mantra that there would be no default long after it was clear to everyone else that there would be. The ECB already has enough tasks. Let's keep them out of the ratings business.
- The Commission should also not be involved in providing sovereign ratings. The Commission is the EU's "policeman" in relation to fiscal discipline, though it's hard to argue that it has done this job well. The Commission issuing sovereign downgrades would be an admission that it has not done its fiscal policing job well. It would also be an acknowledgement of the possibility of sovereign default, a topic most bureaucrats prefer to steer clear of.

Another proposal that did not make the final cut was the establishment of an official European Credit Rating Agency initially set up as public\private structure with public subsidies. There is case to be made that a new well-resourced and independent competitor in the ratings industry could have a positive effect. However, a publicly-sponsored European agency is likely to have serious reputational problems. One must presume that this is the agency that M. Junker expects to provide higher ratings for European sovereigns. But that is exactly why private investors will be suspicious about the reliability of ratings from this source. Overall, the argument for a public agency to participate competitively in the issuer-pays market is weak.

A more promising set of proposals relate to a more radical overhaul of the industry, replacing the issuer-pays model and the many incentive problems that go with it. There are many possible alternative models but the principal one that has been discussed involves a central (not necessarily public) body that assigns ratings agencies to issuers. The funding of such an approach could come from a mix of sources such as a tax on financial institutions or a charge applied to issuers (who no longer pick their raters). Deb and Murphy (2009) provide a well-developed concrete model for how such a system would work, with taxes charged on the financial industry used to provide a subsidy to raters, which is minimised by collecting fees obtained in auctions from ratings agencies bidding for work.

The Commission is proposing to publish a report on credit rating agencies' remuneration models in December 2012. I would encourage them to consider a bold restructuring. Such a move could have a far more positive impact than the full package of proposals that have just been put forward.

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