Finance Watch
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COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
EUROPEAN PARLIAMENT

Public Hearing on Credit Rating Agencies

Tuesday, 24 January 2012

Finance Watch would like to thank the Committee on Economic and Monetary Affairs of the European Parliament for its invitation to participate in this hearing.

Among the different sub-topics on the agenda today, I will concentrate on what is, in Finance Watch's view, the single most important one: the over-reliance of the entire financial system on external credit ratings. I will suggest a simple solution that could contribute to reducing significantly this over-reliance and some of its most negative effects.

The issue of over-reliance of the financial system on credit ratings is a well known phenomenon and so is the most negative consequence of this over-reliance, namely the procyclical effect of rating publications. If need be, the downgrading of nine European countries on Friday 13th January by Standard & Poor's brought another proof of the absurd situation we seem to have locked ourselves into: the first reason given by Standard & Poor's for the downgrading was "tightening credit conditions" and its decision to downgrade nine countries, among which two formerly AAA rated countries (Austria and France), led mechanically to the downgrading of the European Financial Stability Fund (EFSF) which, everything else being equal, can only make credit conditions in the Euro zone more difficult given the role of the EFSF.

The key reason why credit ratings have such a strong procyclical effect is that credit rating agencies are judge and jury. We will see however that it is possible to build a system where credit rating agencies keep their "judge role" but abandon their role as "jury".

1. Distinguishing between "judge" and "jury"

Credit rating agencies play two roles.

- In their first role (the "judge role"), credit rating agencies assess the credit worthiness of borrowers and give an opinion of that credit worthiness. This opinion is expected to be derived from a thorough and independent credit analysis founded on a well defined methodology. In this role, the main asset of credit rating agencies is, or should be, the moral credibility that they derive from high standards of professionalism and from the quality of their track record. It is ironic to see that despite the very harsh criticisms that the three main credit rating agencies have received on the back of their track record over the past few years and of the responsibility they bear in the financial crisis of 2007 / 2008 they are still at the center of the system and they have not seen their market share diminish. This apparent paradox is the direct consequence of the role that credit rating agencies play as "jury" of the financial system.

- In their second role (the "jury role"), credit rating agencies have a direct impact on market conditions, which in turn generates the procyclical effects described above. This "jury role" of credit rating agencies has three main causes:
    1. The explicit reference to credit ratings encountered everywhere in financial regulation: Basle III/CRD 4, Solvency II, European Central Bank collateral rules for liquidity provision and market operations, national legislations, etc…
    2. The fact that many asset management firms have "given up" making their own credit assessment or, even worse, have written internal rules linking their investment decisions automatically to externally attributed ratings.
    3. The way credit ratings are expressed by the agencies ("AAA", "Aa1", "BB", "investment grade", "non investment grade", "junk" etc…). Beyond its obvious marketing effectiveness, this "aggressive" and "judgmental" way of expressing credit opinions has the double negative consequence of feeding the now well documented "cliff effect" and of exacerbating financial markets' herd psychology. For instance, the "cliff effect" is particularly obvious when a rating goes from "investment grade" into "non-investment grade" territory as "investment grade" and "non-investment grade" are arbitrary concepts with no economic or financial relevance simply meant to shock market participants' minds. This phenomenon is reinforced by the fact that the credit rating market operates as an oligopoly which, by definition, gives an enormous importance to the "rating verdict" expressed by the members of the oligopoly (the three dominating agencies currently share between them 95% of the credit rating market).

2. <u>How to keep the "judge" role of credit rating agencies whilst getting rid of their "jury" role</u>

Issuing credit worthiness opinions reflecting a probability of default of borrowers makes economic sense and is useful for financial markets participants. But the key to regulating a business which can be summarized as "selling opinions" is that no single opinion should ever be allowed to influence the entire system as all opinions are, by definition, subject to the possibility of error or manipulation. In the specific case of credit rating agencies, no single credit opinion should ever be allowed to dominate the others nor have by itself the power to impact significantly financial markets or economic decisions.

A few simple measures taken simultaneously could contribute to achieving that result. Several of those measures are already part of the Directive and Regulation proposals released by the European Commission on 15 November 2011. These proposals could, in our view, be easily completed and amended to form a comprehensive package that would put an end to the over-reliance of financial markets on credit rating agencies whilst preserving their useful function as providers of credit opinions.

- The single most important measure would be to change the form under which credit ratings are expressed. Credit ratings are meant to be opinions reflecting a probability of default. They should therefore come out as an opinion (i.e. a text giving arguments), a probability of default, possibly a few other quantitative measures such as “loss given default” and nothing else. Simultaneously, the current way of expressing credit ratings using letters, numbers and symbols (e.g. AA^-, BBB, Baa3, “investment grade”, “non investment grade”, etc…) should be prohibited. This measure should be taken, in any case, for unsolicited ratings and in particular for unsolicited ratings of sovereign issuers.
- The probabilities of default produced by the various rating agencies would then be used to “feed” the European Rating Index (EURIX) managed by ESMA (as proposed in articles 11a and 21 of the Regulation). ESMA would compute an “average probability of default” and this “average probability of default” could then be used by market participants. ESMA would receive probabilities of default for various issuers from as wide a range as possible of duly authorized rating agencies and, in an ideal world, at least five inputs should be used to compute the average probability of default of a particular issuer. It could be investigated whether “extreme” probabilities of default should be excluded from the sample used to compute the average, very much like extreme quotations are excluded from the sample of interest rates taken every day from banks to calculate reference money market rates such as Euribor or others. In the current sovereign debt crisis environment, such an average probability of default would clearly be much more meaningful than a “letter judgment” given by a specific agency.

These two simple measures by themselves would have the triple merit of killing the “cliff effect” generated by the current credit rating system, of avoiding the perverse psychological consequences of the current “good grade / bad grade” system and of letting no single opinion be in a position to influence the entire system. Moreover, reading directly a probability of default would be more useful for finance professionals than reading a letter score that they often need to convert into a probability of default anyway.

On the back of those measures, other measures should also be taken (it must be noted that many of them are, to a large extent, already in the Directive and Regulation proposals made in November by the Commission):

- All references to external credit ratings should be systematically deleted from existing regulations, directives or guidelines (ESAs, CRD, Solvency, ECB rules…) as partially reflected in article 5 of the Regulation proposal and replaced by the "average probability of default" published by ESMA.
- Fund managers should not only be "required not to solely or mechanistically rely on external credit ratings" (Articles 1 and 2 of the amending Directive) but also be forced to remove from their internal rules all references to credit ratings.
- Credit rating agencies' methodologies should be open and freely accessible to everybody so that investors can judge by themselves whether they think the methodology underlying a particular opinion is appropriate. However, we are skeptical that rating methodologies should be approved ex-ante by the supervisor (ESMA) as this might reinforce the blind reliance of the financial system on external opinions ("since methodology has been approved, the resulting opinion must be right") when what we need today is market participants making their own judgment. ESMA's role on methodology should be limited to checking that credit rating agencies publish and update the actual methodology they use to produce their credit opinions.
- Sources of information should be open and no privileged information should be communicated to rating agencies by issuers. Issuers should be forced to disclose 100% of the information they provide to rating agencies as any retention of information increases de facto the reliance of investors on credit rating agencies ("they know something that I do not know").

<u>Conclusion</u>

We need to bring the world of credit ratings back to where everybody agrees it should belong: a purely technical work that consists of issuing credit opinions expressing probabilities of default in a dispassionate manner. The measures proposed here could contribute to that result.

When debating about credit rating agencies regulation, we also need to be careful not to implement measures which, with good intentions, could lead to the perverse effect of reinforcing the overreliance of investors on credit ratings. The objective today is less to try to ensure that nobody will ever make a mistake than to build a system where, when someone makes a mistake, that mistake does not convert into a global disaster.

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