DO WE STILL NEED CREDIT RATING AGENCIES?

THE FAILURE OF THE REGULATOR

Paper – June 2013

This paper was co-authored by Francesco Grillo, Jeanne Laperrouze and Annalisa Cappellini. An initial version of the paper was first introduced and discussed during the XXII Economic Forum in Krynica Zdròz, in Poland on the 6th of September 2012. The current version of the paper has been drafted in order to feed the discussion at the Vision seminar held in Trento, at the "Festival of Economics" on the 1st June 2013.

The two Big Crises that have recently whipped off assets worth hundreds of billions have, according to some, almost killed capitalism. By exposing the failures of markets that were supposed to be "perfect", the collapse of America's housing market, following the bankruptcy of Lehman Brother and the European sovereign crisis, have put under spotlight a very particular category of firms that are responsible for a relatively small and yet crucial portion of the machinery of global financial markets.

The Credit Rating Agencies, in fact, are amongst the entities that are supposed to provide a crucial asset for the correct functioning of global economies; asset that is still badly missing: knowledge, knowledge of the risks that nobody appears to be able to control any longer.

Even the information that CRAs convey does not seem to solve the problem: huge criticisms against CRAs were raised when they failed to foresee Lehman Brothers' default. Not less dissatisfaction is nowadays expressed by both European governments and the European Union following the continuous downgrading of European sovereign debts. Agencies are said to be over optimistic with big banks and conversely too negative with States.

However, the debate on CRAS does not seem likely to produce any solution. In our opinion there are still a number of very basic, fundamental questions that need to be addressed:

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Do we still need credit rating agencies? Is the industry of credit rating and more specifically are the three big rating firms adding or subtracting economic value to financial markets and economy in general? Are they protecting stability of rating users or multiplying volatility? And if there is a dysfunction, who is to be blamed? The agencies themselves or primarily the regulators and the investors who are over relying on their opinions? Where could a solution be found? Do we need more or less regulation? Or do we need something completely different?

1. THE PROBLEM 3

2. LIMITS OF MAINSTREAM APPROACHES TO CRAs REGULATION.............. 7

3. SOLVING THE PROBLEM THROUGH MORE COMPETITION 10

4. A SIMPLER IDEA: RATING THE RATERS 12

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1. THE PROBLEM

A credit rating agency (CRA) is a company that assigns credit ratings to institutions (financial institutions, public companies, financial instruments, international, national and local institutions) issuing debt obligations. The credit rating measures the creditworthiness and the ability to service an obligation in full and on time. By providing credit risk information to market participants (issuers, investors, regulators, states who use this rating in their decision making), CRAs play an important role in the financial market as they are supposed to reduce the so called information asymmetry: the borrower is capable to make more informed decision than the lender and may, ultimately, make financial markets less transparent and interest rates higher in order to compensate the risk. As the interest rate depends on the risk of the investment, the credit rating affects the interest rate applied to loans. Therefore, a low-rated security is expected to have a high interest rate, so to compensate for the higher risk and attract buyers. Conversely, a highly rated security should pay lower interest rates (Shreekant Iyengar, 2012).

Credit rating was created a century ago: at the time, industrial and railway companies issued an increasing number of bonds in U.S. financial markets. In 1909, John Moody, a journalist specialised in economic and financial issues, decided to assign ratings to railway companies and immediately after Moody's was born.

Rapidly competitors entered the market: Standard Statistics, Poor's (which merged in 1941 to form Standard & Poor's) and Fitch. The agencies were amongst the few winners of the Big Recession: they provided an answer to the lack of confidence of investors who were facing increasing difficulty to determine the creditworthiness of these companies. However, the real turning point was when references to ratings were included in financial regulations adopted by institutional investors. The ultimate success arrived when regulators started to limit, or ban, the purchase and/or holding of securities rated below a certain rating.

Following globalization and financial deregulation, their scope gradually expanded to the evaluation of nations. Nowadays, the rating business has grown into a multibillion-dollar industry, which involves global and local CRAs. There are over 150 CRAs worldwide, but few of them rate sovereigns or transnational companies. The global rating business is a highly concentrated market: three companies (Standard & Poor’s, Moody’s and Fitch), hold 95% global market share.[1]

Over the last decades, the rating industry has faced many critics due to its role in financial turmoil, the over reliance on ratings, the oligopolistic structure of market and the lack of transparency. The subprime crisis deeply shocked the regulators confidence in credit ratings. Since then, lawmakers have decided to better supervise the agency business and to address the following issues:

Business model and CRAs independence

Originally, CRAs relied on a “subscriber-based” business model: they diffused the ratings to subscribers of their publications. Whilst most smaller CRAs incomes still arise from this model, the larger CRAs adopted a “issuers-pays” model: CRAs charge the issuer a fee at the time of issuance and an annual fee for as long as the issue is outstanding. In addition, CRAs offer ancillary services. CRAs can both advise an issuer on the design of innovation products and rate them afterwards. Criticisms emerged in relation to conflicts of interest because of CRAS mode of remuneration, since much of their income comes from debt issuers to which agencies assign ratings.

[1] S&P and Moody’s hold 40% market share each while Fitch Rating holds 15%.

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Sovereign ratings are generally unsolicited by the states and the amount charged to states soliciting a rating is unclear. According to Norbert Gaillard, a French economist specialised in sovereign rating, this amount can vary from thousands to several hundred thousand Euros or dollars per year. The economist has pointed out that it is likely that some countries, such as France and Germany, do not pay the rating agencies.

Oligopolistic structure of the market

There are over 150 CRAs worldwide, but few of them rate sovereigns or transnational companies. The global rating business is a highly concentrated market with high barriers to entry, both in terms of reputation and high start up costs, which has left little or no room for new CRAs with other business model and/or ranking methods.

The consequence of monopoly could be so negative that sooner or later an entire industry could be destroyed: lack of motivation to innovate in new products creating economic value, prestige without effort; little or no power on the clients' side; decline of the ratio between added value (in terms of information) and price paid for it; widespread dissatisfaction.

Over reliance and overshooting

In the late 1990s, CRAs failed to foresee the Asian crisis. In 2008, several companies fell into insolvency and went bankrupted during the subprime crisis, whereas they were given a rating considered safe or even a "AAA", as in the case of the Lehman Brother bank. Once a crisis is confirmed, CRAs agencies tend to overreact. For instance, at the premises of the European Sovereign Debt Crisis, Greece was downgraded while already under an international program. Paradoxically, despite these critics and failures, an excessive reliance is placed on credit rating. The immediate consequence is the rise of interest rates and the exacerbation of the crisis (pro-cyclical role). Furthermore, sovereign's downgrades increase the volatility of the markets and might generate spillover effects across financial market and countries depending on the nature of their financial relations (Rabah Arezki, Bertrand Candelon, 2011).

Methodology, transparency and sovereign rating

The main CRAs take in account several quantitative indicators to rate sovereign creditworthiness: GDP per capita, GDP growth, inflation, fiscal balance, external balances, external debt, default history. The factor of political risk is also evaluated. However, "the agencies do not reveal any details regarding the weights they attach to each of these indicators" (Shreekant Iyengar, 2012). The only output of CRAs is the score they assign. Furthermore, although Moody's and S&P use the same determinants, the rating they assigned can significantly differ from one state to another, and the average difference in the rating provided tends to increase (Shreekant Iyengar, 2012).

However, the issue remains: how reliable and capable to add value are the ratings released by the CRAs? How much information are they able to provide in the case of sovereign debts?

The graph below (graph1) shows the ratings released by the Big Three against the ratio between public deficit and GDP as one the main indicator that economists would use to assess sovereigns' financial stability.[2]

[2] To obtain these figure, we replaced the letters used in the ratings with numbers by assigning 25 points to the triple A and subtracting one point for each notch below

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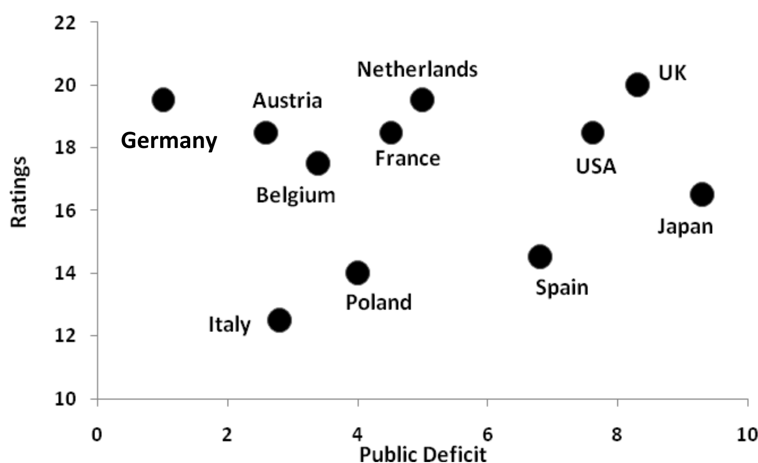
Graph 1: Correlation between S&P Ratings and Sovereign Solvency Ratio (2011)



Source: Vision on IMF, Eurostat, Bloomberg and S&P data.

The correlation appears very low and it is quite surprising to see UK having one of the highest public deficit and the best rating, whereas the opposite is true for Italy.

The table below provides a more complete picture of ratings compared with both public deficit and with the ratio between public debt and GDP, as well as GDP growth rates.

Table 1: Correlation between ratings, market price and sovereign ratios

	S&P Ratings (2011)	Public Deficit over GDP (2012)	Public Debt over GDP (2012)	GDP Growth Rate (2012)	10 Years Interest Rate (2011)
Austria	aa+neg	-2,60 %	73,4	2,00 %	1,98
Belgium	Aaneg	-3,40 %	99,6	-0,40 %	2,54
France	aa+neg	-4,50 %	90,2	0,30 %	2,14
Germany	Aaaneg	-1,00 %	81,9	1,00 %	1,37
Italy	bbb+neg	-2,80 %	127	-2,50 %	5,78
Netherland	Aaaneg	-5,00 %	71,2	-0,50 %	1,75
Spain	Aneg	-6,80 %	84,2	-1,00 %	6,44
UK	Aaa	-8,30 %	90	-0,50 %	1,62
USA	aa+neg	-7,60 %	101,8	2,30 %	1,65
Japan	aa-neg	-9,30 %	218,9	3,50 %	0,8
Poland	a-	-4,00 %	55,6	3,50 %	4,91

Correlation	**Public deficit**	**Public Debt**	**GDP Growth Rate**	**Interest Rate**
Ratings	-0,07	-0,13	0,13	0,85

Source: Vision on IMF, Eurostat, Bloomberg and S&P data.

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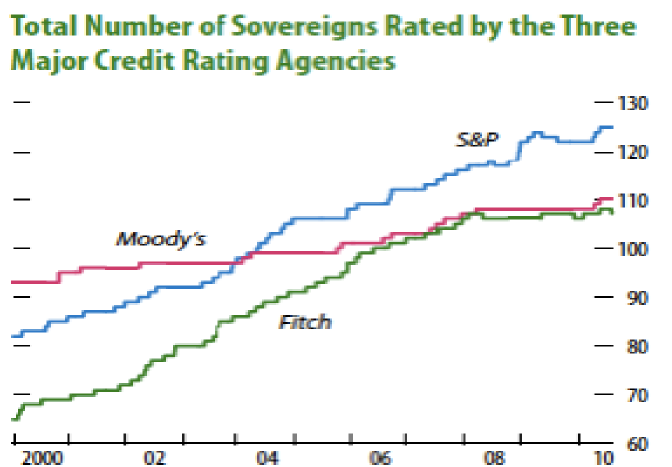
Ratings appear to be weakly (if not even negatively) correlated with each of the other parameters associated with government's solvability.

The only indicator that is positively and strongly associated with ratings is the curve of interest rates. This is the confirmation that either ratings follow market sentiments or that they reinforce them: both ratings and interest rates prevailing on markets are not, however, reflecting the parameters that economists, financial organizations and International Treaties (like the European Stability Pact) consider in order to assess the capability of a sovereign debtor to re-pay its obligations.

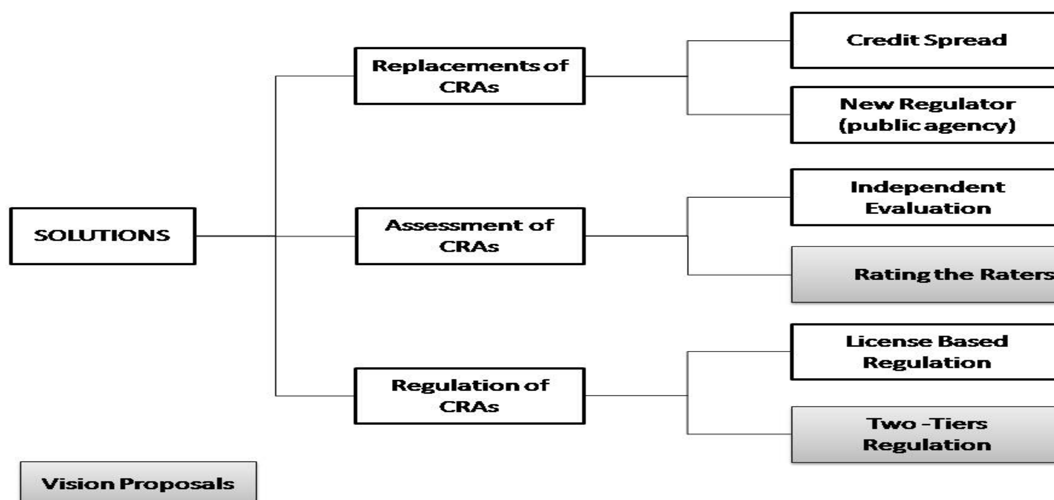
The paradox, however, is that despite all the critiques, the number of countries asking an assessment has been booming (see graph 2).

Graph 2: Total number of sovereigns rated by the three major CRAs (2000-2010)



Source: IMF 2010.

Demand of CRA's services has increased while clients were increasingly expressing dissatisfaction**.**
A number of solutions have been tried by regulators and analysts have suggesting a few innovative ideas. Vision itself has been proposing some solutions that may provide a sort of "third way" between too much or too little regulation. The following chart depicts the possible approaches that we will analyze in the next sections.



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Whereas the approaches of many has been oscillating between responding through over regulation (or even top down creation of new "public" raters) or no response at all (depending on the prevailing mood amongst public opinions and market makers), we propose a sort of "third way": "rating the raters" on the basis of their past performance which is, in fact, a project which Vision is already developing; or a "two tier regulation" where CRAS may voluntarily choose to accept higher level of control in exchange of the possibility for public institutions to use their opinions.

2. LIMITS OF MAINSTREAM APPROACHES TO CRAs REGULATION

Until the late 2000's, the International Organisation of Securities Commissions governed the CRAs activities throughout a self-regulation based code. While responding to the wake of the crisis, many countries started to implement new frameworks to regulate the rating industry. These frameworks mainly consist in registration and supervision of the CRAs.

The US Regulation

In the US, CRAs are registered by the Security Exchange Commission (SEC) as Nationally Recognized Statistical Rating Organizations (NRSROs) and regulated under the provisions of the Credit Rating Agency Reform Act in 2006. Following the subprime crisis, the Congress implemented an additional financial regulation reform. In 2010 the Dodd-Frank Act, supplemented by several news rules adopted in 2011, expanded regulation of credit rating agencies[3]. The provisions include:

- The creation of an **Office of Credit Ratings,** within the Security Exchange Commission, to administer regulations and conduct annual examinations.
- NRSROs are required to publicly **disclose** information on credit ratings issued, including rating methodology data utilized to enable users to evaluate NRSROs.
- Dispositions to **suspend or revoke the rating agency's authorization**, and to penalize individual agency employees for misconduct;
- The Dodd Frank Act **requires federal agencies**, like the SEC and the Federal Reserve, **to remove references to ratings from their own regulations,** when those ratings are used to assess the creditworthiness of a security or money market instrument.

While trying to figure out how to improve the regulation of the financial market, the SEC gathered academics, analysts and mortgages investors to formulate a revision of the Securities Industry Law. The reform would consist in bringing private equity fund managers and venture capital funds under the supervision of the SEC so to ensure transparency in the sector. Commodity exchanges, credit rating agencies,

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[3] Amongst proposals on the wider debate on financial markets regulation, it is worthwhile to mention the one from Nouriel Roubini and Spethen Mihm who suggested in their 'Crisis Economics'? (2010) that all institutional investors pay into a common pool that would be administered by regulators; for every new issuance of debt, this pool would be used to purchase ratings from a group of sanctioned agencies; this solution would require that all players in the financial system (even hedge funds) contribute to the pool.

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hedge funds, and nominee account operators are other entities expected to be affected by the reform. The Securities and Exchange Commission organized a roundtable on May 14th including, among others, top officials of each of the Big Three. Relatively to the rating issue, the main scope of this roundtable was to find a way to mitigate the so-called "rating shopping"; the practice through which an investment bank solicits ratings from multiple CRAs for a product and then only pays for and discloses the most favorable rating received. Moreover, the roundtable had the goal to further address the over-reliance and mitigate conflict of interests. The debate[4] focused on:

- The creation of a government-mandated **clearinghouse** that would randomly assign credit rating agency to issue ratings of structured finance product;
- The promotion of **unsolicited ratings** from credit rating agencies to provide checks on primary ratings;
- **Alternatives to the current business-models**, to address the "issuers-pays "model.[5]

The European regulation

Aiming to reduce the over reliance on rating, to mitigate the question of conflicts of interest, to improve the quality of rating process and to increase the competition in the sector, the European Union implemented the Regulation (1060/09 on Credit rating agencies or CRA I) which entered into force on December 2009. In 2011, the first revision of this regulation (CRA II) created the European Securities and Market Authority (ESMA), an independent UE authority in charge of the safeguarding of the stability of the European Union's financial system. The ESMA is "exclusively responsible for the registration and supervision of Credit Rating Agencies in the European Union".[6] The applicants who can fulfill the following obligations on business conduct are recognized as External Credit Assessment Institutions (ECAI) and allowed to appear in their list.

- **Avoid the conflict of interests**: Every CRA must ensure that its business interest does not impair the independence of the rating credit activities and must establish an internal control. For instance, CRAs must establish a rotation mechanism for employees involved in the credits rating, they also must ensure that their employees do not make proposals regarding the design of financial instruments they are rating.
- **Ensure the quality of ratings and rating methodology**: Every CRA must have appropriate financial and human resources, and may call on external service provider to support them in performing their rating activities. CRAs must review their methodologies and ratings at least once a year.
- **High level of transparency**: The CRA must inform the rated entity at least 12 hour prior the publication so to give the rated entity the opportunity to draw to the CRA's attention any errors. Every CRA must disclose any informations related to their activities, and publish a Transparency Report every year disclosing information about the ownership, internal control, and record-keeping obligations introduced by the regulation (see below).

This supervision of CRAs by the ESMA includes power of investigation and on-site inspection, and authorizes ESAM to impose penalties in case of infringements. The European authority must complete a

[4] See also http://www.sec.gov/spotlight/credit-ratings-roundtable.shtml
[5] The debate will for instance include discussion on business model where firms would continue to pick their raters but the agency would be compensated through transaction fees over the life of the security paid for by both the rater and investor.
[6] See also http://www.esma.europa.eu/page/Credit-Rating-Agencies

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verification of all registered CRAs by 2014. The European Union, in compliance with the Financial Stability Board principles, also made provisions for removing or replacing references to CRA rating in law and regulations "wherever possible" with suitable alternatives.

In January 2013, new rules on sovereigns and private firms' rating were approved by the European Parliament so to further improve the quality of ratings, increase competitiveness and reduce the over-reliance on ratings. The CRA III regulation requires financial institutions to strengthen their own credit risk assessment and to avoid references to external credit. They will allow agencies to issue unsolicited sovereign debt ratings only on set dates, and to avoid market disruption a maximum of three times per year. These ratings will be published after the close of business and at least one hour before the opening of trading venues in the EU. The new rules also aim at making rating agencies more accountable: they state that a rating agency can be held liable in case it infringes intentionally or with gross negligence the CRA Regulation, thereby causing damage to an investor or an issuer. To mitigate the conflict of interest, the new regulation introduces "a mandatory rotation for some complex structured finance instruments, the re-securitisation, and limitations to the shareholding of rating agencies".[7] Furthermore, a European Rating Platform will be set up, where all available ratings will be published to allow comparability and visibility of all ratings for any financial instrument rated by rating agencies registered by the ESMA.

Are these regulations effective? Will the ones that are yet to be applied solve the problem?

If these regulation reforms are meant to increase competition and the number of rating per instrument, we can easily argue that **the regulator has failed to address the high concentration of the market** (Amtenbrink and De Haan 2009) **and thus, the over reliance on credit rating**. The registration process itself increases the financial and reputational barriers to entry, because the criteria are difficult to meet, especially regarding the financial resources required. As a first consequence, we can assume that the market participants ignore the CRAs that are not being certified by the authority whereas others are given more visibility. Another potential loophole of the European regulation is that in order for CRAs to qualify for the registration, they have to set up a subsidiary in the EU, whereas the exception provision are unclear and do not leave enough flexibility for non-European based CRAs. Currently, the Esma registers 30 CRAs,[8] half of them are national subsidiary companies of the Big Three, and only one is non-European. Then, it is not evident whether the registration and the public disclosure of information could increase competition. The example of the US registration system introduced in 2006 by the Credit Agency Reform Act, which led to an increasing number of NRSROs, shows that even new entrants recognized by the SEC could not keep up with the Big Three (White 2010). Therefore, we can also argue that by giving warranties on the good management and monitoring of CRAs to issuers and investors, the registration and supervision process may even reinforce over reliance on the credit rating and the legitimacy and predominance of the Big Three.

Not less doubts may be raised as far as the objective of mitigation of conflict of interest and transparency.

Although the European Commission declares, for instance, its will to "mitigate the conflict of interest due to the issuer-pay model", the CRAs regulation has de facto left it untouched. Furthermore, the ESMA has no say regarding the methodology used by CRAs which are evaluated during the evaluation process. Although CRAs are encouraged to publicly disclose it, "it is not entirely clear to what extend CRAs are expected to reveal their methodologies" (Jakob De Haan, Fabian Amtenbrick, 2011).

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[7] Statement by Commissioner Michel Barnier following the vote in the European Parliament on new European rules to regulate credit rating agencies, 16 January 2013.

[8] See the list of the registered CRAs on http://www.esma.europa.eu/page/List-registered-and-certified-CRAs

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The doubt on conflict of interest is even more fundamental. Conflict of interest may be certainly mitigated by requiring staff rotation; moreover, nobody should ever take part in rating an organization in which he/she has got a financial interest. This is far from solving the problem: the financial market is "a small world" where people are tightly bounded.

Even more fundamentally, some may argue that to have or to have had personal interest into some industry or into some particular issuer may give a competitive advantage in terms of knowledge and experience.

It looks like every attempt to regulate the internal decisions of CRAS may be flawed. This is why we believe that the solution should be found in measuring externally the performance of CRAS.

3. SOLVING THE PROBLEM THROUGH MORE COMPETITION

A stronger regulation of the credit rating agencies has, therefore, being called for. The adoption by the European Parliament of the CRAs Regulation III consists mainly in the reinforcement of the current dispositions which are still, in our opinion, unlikely to address the oligopolistic structure of the market and the over reliance on ratings. Some have argued that it is like trying to solve a disease on the basis of the wrong diagnosis and even with the wrong drug.

Regulators are mainly focused on bringing credit rating agencies to perform a better job and to ensure that they are independent. Instead, the solution may be searched for into a rather opposite direction: encouraging completion and, therefore, the development of a larger and more diversified (and specialized) set of rating instruments amongst which better informed investors may choose.

This seems true for at least two different reasons:

1. **Even the more detailed regulations cannot prevent conflict of interests from occurring**.
2. **Regulators and other public entities are often in a position where they can assess risks better than private firms**: it should be easier (and cheaper) for an authority to collect the required information to assess and predict risks.

These considerations lead us to consider the option to create alternatives to CRAs and competition amongst them:

1. One possibility could be to use directly the information incorporated in the market when ratings appear to simply reflect them without giving much more added value information; or
2. The introduction of institutional competitor to CRAs though the reinforcement of the capability of the regulator itself to assess credit risk; or
3. The development of independent methodologies through which ratings – based on their past performances – are assigned to credit rating agencies.

The first solution is linked to the idea that an analyst will never beat the markets because market movements incorporate the knowledge of many more individuals than rating assignments. If this holds true then it

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follows that instead of using the rating of credit rating agencies, public and private investors should directly look at the markets and at the instruments that signal the likelihood of some debtor to fail. For instance Frank Partnoy, who already recommended to exclude any references to credit ratings from the applicable regulations in 1999, put forward **the possible substitution of credit ratings by credit spreads.**[9] Partnoy pointed out that, "Credit spreads already incorporate the information contained in credit rating.[…] And because credit spreads are determined by the market as a whole, not by any individual entity or entities, a credit spread-based system would not create regulatory licenses for any approved agency" (Frank Partnoy, 1999).

Thus, if credit rating agencies can only follow markets, why should not investors directly establish market-based criteria so that if the price of a certain debt instrument drops under a certain threshold, they will have to disinvest? **The problem inherent with this approach is volatility**: if market movements are automatically reflected in the decisions on resources allocation of investors, they will tend to overshoot both positive and negative trends.

The alternative would be even simpler and would consist in **asking the regulators and the institutions** that monitor debtors to do their own job. By **assessing risks without delegating to private analysts,** a function that, according to some, it is about delivering a public good (risk assessment) that normally is assigned to the State (or the Central Bank, etc..). The indicators (deficit and/or public debt over GDP for sovereign, capital over risks for banks, credit spreads) for assessing risks and guide resources allocations would not even have to be particularly original. Currently, four National Central Banks apply in-house credit assessment systems to evaluate the credit risk of companies.[10] The **drawback** of this solution is that notwithstanding critiques, many would argue that credit risk assessment would **require skills, which are so sophisticated and specialized, and motivations to work hard that are beyond the remit of civil servants**. Such consideration would probably bring us back to the credit rating agencies and to the solution that we would like more: rating the raters (see paragraph 4).

The **new regulation Vision is putting forward is a two tiers regulation**, which would offer the possibility for CRAs to choose between two forms of supervision under which they would have either to disclose their full methodology when issuing sovereigns, or less strict disclosure dispositions for other types of ratings. This proposal arises from the assumption that if the credit rating market must be regulated to prevent conflict of interest and encourage competition, we cannot regulate "opinion", but instead, we should **regulate the use of ratings**.

Under a **"soft disclosure" disposition**, the CRAs would: a) disclose a transparency report in which should be detailed the clients they are rating and advising; b) the stream revenue (both coming from rating and ancillary services); c) any information on direct and indirect shareholdings; d) the ownership interest of its employees; e) the rotation mechanism, and any other information that might enlighten potential conflicts of interest.

CRAs would be allowed to rate financial instruments, without having to comply with a registration procedure, but their activities would be monitored **to prevent conflict of interests**, which can also include investigation procedures when any doubt occurs.

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[9] Credit spread: difference between the yield on the bond and the yield on a risk-free bond of comparable structure and maturity.

[10] The Deutsche Bundesbank, Banco de España, Banque de France, and Oesterreichische Nationalbank form an official source to In-house Credit Assessment Systems (ICASs) as defined by Eurosystem, see also http://www.ecb.int/pub/pdf/other/gendoc2008en.pdf

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Then, **a stronger regulation would apply only to CRAs asking for it on a voluntary basis, so that public bodies could possibly use their ratings. These CRAs should comply with more duties that may extend to the disclosure of their methodology of rating for quality control.** If CRAs do not comply with these rules, or follow certain standards, they would not be excluded from the rating business, but regulators and public authorities should not use the rating they assign. Thus, CRAs would be encouraged to enhance their methodology in favor of a better objectivity when rating sovereigns. Moreover, any actor of the market could access the detailed analysis of the CRAs, and make its own opinion on its accuracy.

In doing so, we believe that a so-called regulation would encourage both diversification and competition by making room to all CRAs and by reducing barriers into entry. It would also make them more accountable when rating states, and it would increase the awareness of ratings users and public bodies.

4. A SIMPLER IDEA: RATING THE RATERS

The solution that we would like to propose has the advantage of simplicity: **rating the raters and assign weights to their ratings based on their past performance.** By following this approach, when one investor needs to take decisions she or he would use a basket of ratings where the relative importance of each of them is linked to the capability of each agency to forecast credit event.

The Issuing Committee put the evaluation of the rating performance monitored by regulators forward in 2008. Goodhart (2008) refers to a CRA Assessment Centre (CRAC) that would be in charge for the evaluation of the accuracy of CRAs ratings and for the regular publication of comparative study of their forecast performance. As Goodhart (2008) argues, "A new entrant could establish a track record for greater accuracy (again independently assessed) in a particular niche by exploiting a comparative advantage, say in rating one particular product line, with a small staff and built from that. What investors want is forecast accuracy. At present they have no simple or straightforward way of checking that […] so most investors fall back on reliance on brand names, which reinforced oligopoly".

Our proposal would go further, and consist in **giving a rating to CRAs based on their accuracy**. The mechanism can be very simple: All CRAs may simply make transparent –again on a voluntary basis – a record of each product. For each credit event issued (including quasi credit event, like a certain fall the debt instrument, or default being avoided only thanks to the financial support of a third party) an independent research company could then rate the credit rating agencies by assessing how accurate was the ratings in anticipating the event. Both the gap between the rating assigned and the one that should have been established and the gap in time (the longer the better) of the downgrading from the event would be considered. The average of the forecasting ability shown by a certain CRA on all defaults that it has foreseen (whereas probably each default should be weighted by its size in terms of debt): this will generate its rating and allow investors to assign an **evidence based value to a certain opinion**. We can even imagine a several sub-ratings of the raters: a rate attributed to the CRAs for each type of instruments they issue (a rate for sovereign ratings, company, and instruments) and a rate on their global activities.

The following table illustrates this methodology to assess the accuracy of CRAs. The experimentation focuses on twenty corporate that defaulted in 2012. For each of the following company, we measured the accuracy of the raters by calculating the distance between the ratings issued one year prior to the credit event and the grade corresponding to default (D).

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Table 2: rating the rater: a template

Corporates (date of default)	S&P Ratings	Accuracy	Moody's rating	Accuracy
Coach America Holdings (Jan 2012)	B- (Nov 2010)	6	Caa1 (Feb 2011)	5
Buffets Inc (Jan 2012)	CCC (Jul 2011)	4	Caa2 (Jun 2011)	4
Hanley Wood LLC (Jan 2012)	CCC- (May 2011)	3	Ca (Aug 2011)	2
The Tensar Corp. (Feb 2012)	CCC (Feb 2011)	4	B1 (Oct 2011)	8
Reichhold Industries Inc (Feb 2012)	B- (Feb 2011)	6	Caa1 (2011)	5
Circus and Eldorado Joint Venture (Mar 2012)	B- (Sept 2011)	6	Caa3 (May 2011)	3
Mohegan Tribal Gaming Authority (Mar 2012)	CCC (May 2011)	4	Caa3 (May 2011)	3
Dex One Corp. (Mar 2012)	B (Oct 2011)	7	B3 (Oct 2011)	6
Hawker Beechcraft Inc (Apr 2012)	CCC+ (Dec 2011)	5	Caa3 (Sept 2011)	3
Reddy Ice Holdings Inc (Apr 2012)	B- (Nov 2011)	6	Caa1 (Nov 2011)	5
Barneys New York Inc (May 2012)	CCC (2009)	4	Caa3 (Jul 2009)	3
Broadview Networks Holdings Inc (Jul 2012)	B (Sept 2011)	7	Caa1 (Jun 2011)	5
ATP Oil & Gas Corp. (Aug 2012)	CCC+ (May 2011)	5	Caa2 (Jun 2010)	4
LifeCare Holdings Inc. (Aug 2012)	CCC- (2010)	3	Caa1 (Apr 2009)	5
AMF Bowling Worldwide Inc (Oct 2012)	CCC+ (Jul 2011)	5	Caa3 (Dec 2011)	3
LBI Media Inc (Oct 2012)	B- (Oct 2011)	6	Caa1 (May 2011)	5
Allen Systems Group Inc. (Nov 2012)	CCC- (Dec 2011)	3	Ba2 (Apr 2011)	10
James River Coal Co. (Nov 2012)	B (Oct 2011)	7	B3 (Mar 2011)	6
Overseas Shipholding Group Inc. (Nov 2012)	B (Dec 2011)	7	B3 (Dec 2011)	6
Edison Mission Energy (Nov 2012)	B- (Sept 2011)	6	B2 (Oct 2011)	7
Average	**9 months**	**5,2**	**10 months**	**4,9**

Source: Vision with S&P and Moody's data.

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The table shows that Moody's assigned more accurate ratings than Standards and Poor's in 2011 relatively to events occurred in 2012 for this sample of companies.

However, to rate a credit rating agency should also consider a **second parameter**: how conservative versus optimistic is a certain CRA. If we only consider how good was a CRA in foreseeing the default, we may create an incentive for being too risk adverse. CRAs may also fall in the opposite mistake to assign ratings which are too low and therefore make debtors pay too much.

The evidence that Vision is collecting seems to say that although it is true that Moody's appeared to have foreseen slightly better credit events as far as the sample that we considered, it is also true that it appeared to have been way more prudent than S&P. Therefore, it is more likely that S&P have underestimated the capability of some debtors to serve their debt with negative consequence on the cost that they ultimately paid.

By applying our methodology the rating of raters would be **bi-dimensional, thus** presenting more judgment and supported by a map that could help any investor to choose according to its own optimal mix of risk versus return.

Applied to a larger sample, such a measure would allow the **improvement of the decisions of the investors** (and thus a reduction of the cost to the community of defaults). It would also introduce more competition and more accountability amongst CRAs by **encouraging better performance and increasing specialization**. This would probably foster both innovation and stability, which are the two terms amongst which any reform of financial markets seems to have hard time to find a compromise.

Increasing markets' stability and capability to manage risks by improving knowledge through better choice and more competition: this is – in a nut shell – what we would like to suggest for the issue of credit rating agencies;the same may apply to the much wider question of smart reforms of global financial markets.

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