Briefing

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The case for a European public credit rating agency

SUMMARY

The 'Big Three' credit rating agencies – Standard & Poor's, Moody's, and Fitch – enjoy an oligopolistic position on the market for the rating of private and public debt. In the run-up to the financial crisis, we now know, they were over-optimistic with their ratings, but once the crisis hit, their ratings went into a very fast downward spiral. This is considered to have contributed to the severity of the crisis. A similar pattern could be observed when the sovereign debt crisis started in the European Union.

In both the USA and in Europe, legislation was enacted to rein in the agencies' power as well as to prevent possible conflicts of interest which might lead to biased ratings. The backward-looking character of the ratings, which were based more on past performance than on a thorough analysis of likely future evolution, came under scrutiny.

Calls were made to create new credit rating agencies, which could, if necessary, be public ones. After some initial enthusiasm, these ideas – and at least one serious attempt – stalled. The main problems were possible accusations of market manipulation, insufficient credibility, and the lack of financing. The European Commission has recently said a new European rating agency would add little to investors' information. It is unclear whether new attempts will be made to create an alternative rating agency, but there are still ways to reduce the hold of the 'Big Three' on the ratings market, including by putting more weight on internal ratings, as well as by relying on third-party assessment.

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Background

The role of a credit rating agency

In essence, ratings are about the reduction of the asymmetry of information between borrowers and lenders. Three roles are the most important: identifying, and quantifying, the risk of a private firm or a public entity defaulting on its debt; helping to determine the appropriate interest rate for a financial product before its launch; and use in a number of other fields, e.g. guidance in the setting of a financial institution's capital requirements, as set down in the Basel framework.

What is a rating, and how is it made?

A credit rating is an opinion, expressed on an alphanumeric scale, on the creditworthiness of a debt issuer, i.e. its ability to honour current and future obligations. Each credit rating agency (CRA) uses its own rating scale (see Table 1). The best-known scale is that of Standard and Poor's, where the top ranking is AAA, and the worst is D (for 'in default'). The one used by Fitch is almost identical to that of Standard and Poor's (S&P), but Moody's rating scale runs from Aaa (highest) to C. The financial products with the lowest ratings are generally known as 'junk'. In addition, ratings are often given an indication on the outlook in form of a '+' or '-', thus hinting at a possible future rate change in the short to medium term.

Table 1 – Rating equivalence between the 'Big Three'

Standard and Poor's	Moody's	Fitch	Credit quality
AAA	Aaa	AAA	Investment grade
AA	Aa	AA	
A	A	A	
BBB	Baa	BBB	
BB	BA	BB	Speculative grade, junk
B	B	B	
CCC	Caa	CCC	
CC	Ca (Likely in or near default)	CC	
R (Under regulatory supervision)	C (Typically in default)	C (Default is imminent or inevitable)	
SD (Selective default)		RD (Restricted default)	
D (General default)		D (In bankruptcy, administration, etc.)	

Data source: House of Lords, EU Committee, report on 'Sovereign credit ratings', 2011.[1] .

The information used by the agencies is mainly ex-post, i.e. based on past performance. In practical terms this means that an agency will watch how the markets have been treating financial products of a given firm, and then adjust their rating accordingly. The information content of ratings is very low, and credit rating agencies refer to their own ratings as an 'opinion'. Some say this is done on purpose, in particular in order to reduce the extent to which they can be held accountable, including in court.

There is a fundamental difference between rating private entities and sovereigns. For the former much information, including private sources, is available to the agencies, whilst for the latter the information is thought essentially to be drawn from the public domain. The information differential is reinforced by the fact that negotiations take place between the agencies and private firms during the rating process, allowing CRAs to request additional information, and thus refine their assessment. By contrast, usually no negotiations take place between governments and agencies, and no additional information is made available to the CRAs, although there can be exceptions.

Ratings are done either on a fixed schedule, often twice a year, or at short notice, for example when there is a sudden decline of market confidence for a given financial product, or if the creditworthiness of a country's government is suddenly put into question.

The users of ratings

Credit ratings are primarily used by investors to obtain cheap, quick and (generally) reliable information, especially when buying bonds or equity. For the investor it is important to verify the creditworthiness of the issuer. For the issuer of debt, the rating is an indication of the interest rates that they will have to offer.

Some investors are bound by law or by their statutes as to the quality of debt instruments they are allowed to buy and hold. This is particularly the case for pension funds. Central banks are also in this category, as they can make financial gains, but also incur losses like any other bank, and therefore have to be careful as far as their balance sheet is concerned. As a consequence they are not allowed to buy what are known as 'junk bonds'.

Who provides ratings

The main rating providers are private firms, yet their ratings are freely available to the public. The three big providers are Standard & Poor's, Moody's, and Fitch. In the USA all three were recognised as 'official' rating agencies in 1975, following the introduction of new rules by the Securities and Exchange Commission. This provided them with a high profile, elevating them almost to a degree of importance, relevance and credibility which is generally limited to government agencies. The three were given the newly created label of Nationally Recognized Statistical Rating Organisation (NRSRO). At first, this resulted in heavily restricted market access, yet markets have been opened up a bit since, and several smaller firms have joined the competition. CRAs were assigned further importance in the assessment of bank portfolios through the Basel II Accord.

It should be borne in mind that a number of financial institutions, such as banks and insurance companies, perform their own ratings (i.e. they do not themselves rate their own creditworthiness, but assess that of financial products they envisage trading). To this end they produce what are called internal ratings, which are based on their own criteria and assessment, and which may also take into account third-party information, including that available from CRAs. Typically, these ratings are not made public, but may be sold to selected clients.

The financing of ratings

Conducting a rating is a difficult and therefore expensive endeavour. Two competing models exist for financing the rating of firms or products from the private sector. The investor-paid model consists of having a potential investor paying to get the financial product rated prior to buying it. Such a rating would not be made public. The issuer-paid model, which is most used today, consists in having the issuer of the product rated paying the cost, with the rating then being made freely available to anyone interested.

In the 1970s, when the Big Three were given NRSRO status by the SEC, the market switched from investor-paid to issuer-paid. It later appeared that had become almost impossible to switch back to an investor-paid system, as the latter is prone to free-riding, and thus cannot compete with issuer-paid ratings. As a consequence the investor-paid method was marginalised after 1975. Governments do not usually pay for their bonds to be rated, so this is therefore essentially a service provided for free by CRAs.

Possible conflicts of interest

Rating agencies face a high risk of conflict of interest, especially in the usual scenario, where the issuer of debt is paying for their rating. There may be an incentive for the CRA to provide a favourable rating, in order to please their client. (Investor-paid ratings are not immune to misstatements in their ratings either, and have been sanctioned for that, as happened in the Egan-Jones case.) Offering an over-enthusiastic rating might also help foster a business relationship, as the rating agencies (or another branch of the companies of which they form part) often sell a range of consultancy products. Furthermore, rating agencies may also themselves sell third-party financial products for which they have provided a rating, in which case a favourable assessment would act as a selling point.

Even without actually succumbing to a conflict of interest, rating agencies may find themselves under suspicion, which can be damaging to their reputation. Reputation is one of the central assets of any rating agency, and the loss of it might drive them out of the market.

Ratings before and during the crises

There is a marked difference between the recent crises in the USA and the EU. Whilst in the USA the main focus was on the financial crisis, the EU faced both a financial crisis and a sovereign debt crisis, which were interlinked. The sovereign debt crisis was not confined to the euro area, as none of the first three EU countries affected were using the euro.

There is evidence that agencies tend to be lax before a bubble is about to burst, only to become very severe once markets head down. Many say that the ratings of a number of private and public financial products were too high before the crises, and that the CRAs did not sense any crisis coming. Furthermore, with respect to the European sovereign debt crisis, it has been noted that the agencies did not see or take into account the imbalances in public finances as well as problems with the lack of sustainability of growth models. However, most analysts outside the agencies did not sense the problems either.

In the USA, private-sector mortgage-backed securities had been rated in a very favourable manner, contributing to the real-estate bubble and fuelling the securitisation process. This is one specific area where over-optimistic ratings were a contributory factor to the financial crisis, and where inevitable downgrades accelerated the crisis.

With regard to the European sovereign debt crisis, for many years prior to the crisis the rating agencies did not sufficiently discriminate between sovereigns with divergent levels of accumulated debt. Once that crisis hit, there was a very fast adaptation, with a quick and brutal lowering of ratings. This could be observed very clearly in the peripheral euro-area economies, which enjoyed a rating privilege prior to the financial crisis, which then turned into a penalty as the crisis unfolded.

There is controversy about how appropriate the ratings of sovereigns were after that adaptation. Some say that the ratings ended up being too low, thus magnifying the impact of the crises, whilst others estimate that, even after the adaptation, they were still more favourable than they should have been. Over-optimistic rates would have been the consequence of the ex-post bias, as well as prevalent conflicts of interest, whereby CRAs would still have been incentivised to over-rate financial products which, de facto, already were junk bonds, or in the process of becoming precisely that.

The successive downgrading of Greece's rates was a factor in the rise of the spreads of long-term government bond yields relative to the German Bund, and contagion to other Member States with less than solid fiscal fundamentals ensued. Euro-area countries like

Belgium, France, Ireland, Italy and Spain also saw their spreads rise and thus came under pressure.

The influence of rating changes on market pricing is much more pronounced during a crisis than during calm periods. There is evidence that a significant reallocation of capital across the euro area that took place following rating announcements that were made during the crises. 'Herding' contagion could be observed for investors, but also for rating agencies, which tend to mimic others' ratings. Also, negative cross-border spillover effects following downgrades are more pronounced than positive spillover effects stemming from upgrades. Finally, there is a rating penalty for those countries whose debt ratios are high and at the same time increasing.

Creating a new European credit rating agency

An attempt to create a European CRA was made in Germany, when Markus Krall, a management consultant with the consulting firm Roland Berger, made a considerable effort to launch a competitor to the 'Big Three' established agencies in 2012. The idea was to create a privately funded agency, organised as a foundation, and which was not geared towards profit-making. It would have started with rating sovereigns, then expand into rating the private financial sector. The long-term aim was to have a worldwide market share of ratings of 25%. Initially, the project got support from leading German politicians, and the European Commission also signalled its approval. However, criticism came fast, especially concerning the availability of finance, the possible lack of independence, and possible conflicts of interest.

Over-reliance on external ratings and the legislative response

It became clear during the crises that an over-reliance on external ratings – especially those from the 'Big Three' – in existing regulation had the effect of pushing market participants to use mainly external ratings, and similarly to reduce investors' incentives to create their own assessment capacity. Together, these factors resulted in a mechanistic use of external ratings. Market participants would then all react in a synchronised manner to downgrades, precipitating pro-cyclical effects.

Following the crises, and the controversy around rating agencies, the legislation regulating them changed both in the USA, where the Dodd-Frank Act was adopted in 2010, and in the European Union in 2013 through the Credit Rating Regulation (Regulation (EU) No 462/2013) and an associated Directive (Directive 2013/14/EU). On both sides of the Atlantic, legislation was modified in order to reduce reference to – and reliance on – external credit ratings. In particular Article 5a of the Credit Rating Regulation stipulates that financial institutions 'shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument.' Amongst other measures, the European Securities and Markets Authority (ESMA), as well as the (US) Office of Credit Rating (OCR) were created and given supervision powers over the CRAs.

Call for public credit rating agencies

The ratings from the established private CRAs came under intense scrutiny during the recent financial crisis, which started in 2007-2008. Criticism then concentrated on the ratings for the financial sector. When the sovereign debt crisis hit in Europe in 2009-2010 the ratings of sovereign debt came under fire too. The quality of the ratings and the independence of the agencies were questioned. This was not just a European issue, but an international one, especially in the USA.

As a consequence of the perceived strong bias towards delivering favourable ratings before the start of the crises, calls were made to supplement the private CRAs with public ones. For example, in the European Parliament's Economic and Monetary Affairs

Committee (ECON) the topic was repeatedly raised, motivated by a latent impression that several Member States' governments had been rated too strictly when they were in distress. This sometimes seemed to be geared towards creating alternative agencies which would provide more 'optimistic' assessments. Various MEPs called for the establishment of a European public CRA, which would have the power to set ratings on its own. It was implied that these ratings would occasionally differ from those of the private CRAs. On 8 June 2011 the European Parliament adopted a resolution requesting the Commission to conduct an impact assessment concerning the creation of a fully independent European Credit Rating Foundation (ECRaF). It further urged the Commission to explore and assess the establishment of a truly independent European credit rating agency.

This idea had already found political support prior to the adoption of the European Parliament resolution, including from the German government. An alternative, published in an International Monetary Fund (IMF) paper, suggested bringing one or more CRAs under public control.

A European public credit rating agency: main challenges and alternatives

Main challenges

While many calls for a public CRA, from parliamentarians as well as government representatives, stakeholders and academics, were motivated by a desire for accurate and fair analysis, i.e. to correct market failure, some may have been motivated by an interest in introducing some political bias into the rating results. Should things move in the latter direction, caution is necessary, as this could lead to the infringement of existing legislation.

The difficulty with raising the necessary finance was the biggest reason why the creation of a European rating agency was not pursued (see Box 'Creating a European CRA').

Attention has been drawn to a reputational problem which a public CRA would face. A public agency (or a private one created under public pressure or with public support) might find itself severely lacking in credibility with capital markets.

However, the main risk for a European public rating agency would probably be the consequences of legal action raised against it. Credit ratings are instruments used in a highly sensitive environment. In the financial services sector much effort is put into the correct rendering of facts. Incorrect reporting – or the voluntary introduction of a bias – fall under laws sanctioning market manipulation. Market manipulation is no minor matter, as it can result in very high costs for market participants. Market manipulation can lead to criminal charges, and even when not considered a criminal offence, it can still involve very stiff fines. As rating agencies are regularly drawn before the courts, they need deep pockets to fight legal action and pay any fines.[2] There is nothing to prevent criminal charges related to market manipulation being raised before a US court against a European public CRA.

The alternatives to a European public credit rating agency

In the absence of a European public CRA many other solutions exist for obtaining more accurate and reliable ratings, as well as assessing default risks:[3]

- increasing the quality of the CRAs' products, including through better legislation (the Commission intends to make proposals for amending CRA legislation at the end of 2016);

- using internal ratings (e.g. those prepared inside a bank prior to buying specific financial products);[4]
- relying on market-derived information such as credit default swaps (CDS),[5] as well as bonds or equity information;
- using accountancy measures such as profitability and leverage ratios for assessing firms;
- seeking advice from investment banks and industry analysts;
- using new entrants to the credit rating market as alternatives to the 'Big Three';[6]
- using studies, e.g. those prepared by the OECD or central banks.

Practical example – Findings of an alternative assessment of sovereign default risk in the EU

The European Commission's Fiscal Sustainability Report 2015 estimates that in the short term (one year) no EU country appear to be at risk, in the medium term (up to 10 years) 10 countries appear to face potential high risks, and in the long term only one country appears to be at high sustainability risk. The report did only assess the risks of the 26 countries that were not under macroeconomic adjustment programmes (Cyprus and Greece were therefore excluded).

Concerning the probability of a sovereign default in the EU, in-depth assessment information is provided by the Commission in its Fiscal Sustainability Report, which is published every third year. Contrary to the rather backward-looking analysis commonly practiced by CRAs, the Fiscal Sustainability Report is strongly forward-looking, and is furthermore based on a transparent methodology. In addition, concerning sovereigns, the Commission has since come to the conclusion that the introduction of a European creditworthiness assessment would add little value to the information already existing.

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Endnotes

[1] This table is an indicative overview, as a number of qualifiers are used by the CRAs, resulting in additional categories such as 'BBB+' (S&P) or Baa1 (Moody's). The table only concerns long-term ratings. For the short term other categories and letters are used, such as 'A-1 +' (S&P), 'P-1' (Moody's) and 'F1 +' (Fitch), which all three describe top-notch short-term credit quality. Partial overlap of categories may complicate comparisons between ratings.

[2] To give an example, Standard and Poor's agreed a US$1.37 billion settlement in February 2015 (in addition to other fines in excess of US$200 million). This might at first seem to be a high penalty, but it allowed S&P not to admit criminal wrongdoing. The latter would have been even more costly for S&P, both in fines and in reputational damage.

[3] The Commission's Study on the Feasibility of Alternatives to Credit Ratings provides a detailed analysis, with pros and cons of the main solutions.

[4] The Commission's study finds that internal ratings are the most used alternative to external ratings. However costs are high, especially for the investors, who face costs for obtaining data; developing tools for analysing data; employing specialised analysts; and putting into place a system of quality control. It further points to a possible lack of available data. Another study, published by the Bank for International Settlements, finds that both external and internal ratings tend to underestimate what are called 'event risks', such as the unwillingness to pay (especially by governments), as opposed to the incapacity to pay.

[5] An ECB study however finds that high CDS premia may mainly reflect the market's rising risk aversion for a specific financial instrument, rather than give an indication of the probability of a future default on that instrument.

[6] The Big Three do not rate Portugal's public debt instruments as being investment grade, but Canadian rating agency DBRS does, which allows the ECB to continue purchasing Portuguese government bonds on the secondary market.

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