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Ratings Agency Reform: Shooting the Messengers?

Briefing 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.

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

[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.

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 2 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 2 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 if internal risk assessments that the Commission is hoping for.

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

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

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 2 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 2 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 that[4]

"*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.

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.

[3] See Basle Committee on Banking Supervision (2006).
[4] eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF

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 (ECAF) 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.

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.

[5] See Chapter 6 of ECB (2011).

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

- Jean-Claude Junker, Luxembourg's prime minister and chairman of the Eurogoup 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] Junker 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]

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.

[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.
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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/AboutMoodysRatingsAttachments/2000400000300541.pdf for documentation.

2. Informational 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-aired 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 attached 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

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

"*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 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.

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

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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