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Whipping boys

DO THE CREDIT RATINGS AGENCIES DESERVE ANY SYMPATHY? A RECENT ROUNDTABLE DISCUSSION SUGGESTED THAT EU PROPOSALS TO REGULATE THEM MORE TIGHTLY MAY DO MORE HARM THAN GOOD. **GRAHAM BUCK** REPORTS.

The brief uneasy calm in the euro zone crisis that descended at the end of last year wasn't maintained long into 2012. On 13 January, ratings agency Standard & Poor's reduced France's AAA credit rating to AA+ and downgraded eight other EU countries, leaving Germany the only major euro zone economy to maintain a AAA rating.

The move, when it finally came, saw S&P attract less criticism than two months earlier. In November it had jumped the gun by accidentally releasing a message to subscribers announcing that France had been downgraded and had to retract it quickly. The French reaction was furious, with the country's market regulator AMF announcing it would launch an investigation into the error.

During the brief period between the phoney downgrade and the real one, independent thinktank the Centre for the Study of Financial Innovation (CSFI) presented a roundtable discussion on the credit rating agencies in early December. It took as its title "Are we beginning to feel sorry for the credit ratings agencies?" Participants included representatives from the three main agencies – Christopher Lake of S&P, Susan Launi of Fitch and Nigel Phipps of Moody's – as well as the ACT's policy and technical director John Grout, and Richard Hopkin, managing director in the securitisation division of the Association for Financial Markets in Europe (AFME).

Given that S&P also ruffled feathers by applying a similar downgrade to the US federal government's credit rating last August, sympathy might be expected to be in short supply. But the CSFI noted that the ratings agencies had been cast – possibly unfairly – as one of the "popular villains in the financial crisis" for failing to sound the alarm early on over the mis-selling of bundles of sub-prime mortgages, collateralised debt obligations and other complex loan packages.

"The irony is that [the ratings agencies] only claim to sell an opinion, but somehow these opinions have become a formal part of the regulatory landscape," the CSFI noted.

The topic for roundtable discussions was based on the premise that the ratings agencies' record on both government debt and corporate debt was of much longer standing than more recently devised instruments, yet ratings agencies were now under pressure "to go easy on certain sovereign issuers". This pressure had been added to in the EU both by European Commission proposals and the new supervisory powers being exercised by the European Securities and Markets Authority (ESMA).

The ratings agencies' representatives at the session confirmed that their organisations were keenly aware of operating under the spotlight, took their responsibilities seriously and recognised that inevitably not all of their pronouncements would ultimately turn out to be correct.

They also denied the suggestion of some critics that ratings agencies were resistant to regulation and supervision. They were already "feeling the heat" from ESMA, whose head Stephen Maijoor had pledged that his teams would visit the offices of the major ratings agencies before the end of 2011.

EUROPEAN REGULATION The first European Commission regulation on ratings agencies (CRA I) came into force in December 2009, introducing "a harmonised approach" to regulating their activities in the EU and establishing a registration system.

"We have teams of ESMA supervisors on our premises, checking that the processes and methodologies in CRA I are being applied," said one ratings agency representative at the breakfast briefing. "Processes that surround our issuance of ratings are being thoroughly scrutinised."

In June 2010 CRA I was amended by CRA II. In addition to

confirming that ESMA would assume responsibility for approving the registration of ratings agencies, ongoing supervision and any enforcement action, the regulation proposed a new regime for greater transparency of ratings for complex, structured finance instruments. The aim was greater competition by increasing the amount of information available to rival ratings agencies and to give investors greater choice.

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However, last November the European Commission announced that “recent developments in the context of the euro debt crisis have shown our existing regulatory framework is not good enough. The Commission has put forward proposals to toughen that framework further and deal with outstanding weaknesses.”

Among the new proposals in CRA III were measures:

- to reduce overreliance on ratings – financial institutions would not rely solely on credit ratings when picking investments but be required to make their own assessments, and ratings agencies would have to provide more details about their ratings;
- to require more frequent assessment of national debt ratings – ratings agencies would in future update EU countries’ ratings twice a year instead of annually;
- to ensure independence – debt issuers would be require to rotate every three years between the agencies rating them. For more complex debt instruments, ratings from two different ratings agencies would be required; and
- to make agencies more accountable – investors would be empowered to bring civil liability claims against any ratings agency that breached EU rules.

The aim of reducing what the European Central Bank’s new president Mario Draghi has called a “mechanistic reliance on ratings” was supported by roundtable delegates. However, several expressed concerns about the new ESMA regime and the proposed extension of regulations outlined in CRA III. “Supervisors are checking that the methodology is being applied properly but aren’t actually checking the methodology itself – and the EU’s regulatory authorities aren’t permitted to make any intervention,” said one.

There was also general consensus that the aim of improving the quality of ratings could actually be undermined by CRA III’s proposals and that they would also fail to improve competition. “It’s more likely that the effect will be to further increase the dominance of Moody’s and S&P,” was one comment. At least one additional proposal in an early draft of CRA III – that two agencies should be involved in rating all debt instruments, whether complex or not – had been dropped at a later stage.

CORPORATE FINANCING Another crucial issue that the European Commission failed to address was how European corporates would manage to access enough finance in future. “There is a total refinancing need of around $900bn in Europe over the next few years,” one delegate noted. “Currently around 50% of this debt load gets financed from outside the EU, but the proposals would make achieving this financing need impossible in future.”

One glimmer of hope was that the Commission had some “market liberals”, particularly in eastern Europe, who recognised the danger and were “fighting to get a different result”. Unfortunately, the UK’s concerns carried less weight. “The British attitude comes across to other EU members as patronising and merely irritates Brussels,” commented one.

The proposal to enable investors to bring claims was also slated. “Ratings agencies are not well-capitalised organisations,” a delegate suggested. “It’s right that they should be held to account, but by sensible regulation and supervision rather than through the law courts.” S&P’s slip-up in November over France’s credit rating raised the question of whether such a mistake would be regarded as a violation of the new regulations being proposed.

Grout was also gloomy about the implications for corporates. “This type of draft regulation is really depressing,” he said. “If the banks are being shut down as a prime source of lending, as they are, then it will be even more difficult to get funding and corporate ratings will become more important than ever.”

To conclude the session, delegates were asked how they expected the latest proposed regulations to progress as they moved from draft to final legislation. Opinion was divided, with one delegate expressing confidence that there would be “significant changes” introduced in response to the concerns voiced. Not everyone agreed. “I’m more pessimistic,” said another. “I fear that it will be waved through pretty much intact as a result of political compromise.”

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org