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Rating Agencies: Are They Necessary, Superfluous, a Necessary Evil or Harmful?

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The opinions expressed here are exclusively those of the authors.

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Foreword

Neoclassical economic theory mentions, among other things, perfect information as a key condition of market functioning. Only someone who knows all the characteristics of a product can determine an appropriate price and hinge his or her purchase decision on it.

In practice, however, such comprehensive information is rarely to be had, since the costs of acquiring it, usually, exceed the value of the good itself. Instead of making their own calculations, people thus generally resort to external analyses, in the case of financial market products, to rating agencies. However, as the Subprime Crisis of 2008 and the ensuing global financial crisis have shown the valuations of the rating agencies were false and thus contributed considerably to the crisis. Classic market failure occurred, which to date it has not been possible to eliminate.

With the recent analyses “Basel III and SME Financing” and “Financial Market Regulation: Introduction of a Bank Levy and Financial Transaction Tax at the German and European Levels” the “Financial Policy, Taxation, Budgets and Financial Markets” permanent working group of the Friedrich-Ebert-Stiftung’s Managerkreis has already addressed a number of instruments of financial market regulation. Given the extent of the European debt and refinancing crisis the authors and members of the working group have now taken a closer look at the rating agencies, which have gained influence over entire economies with their evaluations. The reader will discover, with interest, how reliable rating agencies can be in their evaluations and what use they represent.

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1 Abstract

The aim of the present paper is to examine and evaluate the use of rating agencies. Such an evaluation is possible from various standpoints. In this paper we address, on one hand, aspects related to companies and the economy, in particular, the role of rating agencies in capital raising and investment and, on the other hand, questions concerning financial market regulation, in particular banking regulation.

The starting point of the present evaluation is thus influenced by the experiences of the financial market crisis, which began as the so-called Subprime Crisis. The judgement of the National Commission on the Causes of the Financial and Economic Crisis in the United States on the role of the rating agencies was thus negative:

“We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them.” (The Financial Crisis Inquiry Commission 2011: 25)

Overall, we can conclude that the major rating agencies have achieved a global position of power and thus exercise a strong influence over both politics and society. This alone is problematic from a governmental and financial market policy point of view because of the lack of democratic legitimation. Furthermore, the major rating agencies have considerable systemic importance for the financial markets. This results from (i) the oligopolistic market structure and thus the lack of balancing alternative providers; (ii) the fact that miscalculations can have repercussions for the solvency of other financial market actors, in particular credit institutions and insurance companies; (iii) the very widespread and uncritical application of ratings; and (iv) the application of (external) ratings in regulations.

The purpose of the present paper is not to provide a comprehensive overview of the role of the rating agencies in the financial market crisis, but to cast a critical light on the need for them. If there is (still) such a need, for example, from the standpoint of banking regulation, the question remains whether additional providers, such as a European rating agency, are needed.¹ In addition, the political reaction to weaknesses identified in the regulation of rating agencies is considered and the current regulatory proposals are evaluated.

The findings of the paper can be briefly summarised as follows:

- The three major rating agencies have a dominant role in the evaluation of issuers and structured financial products.
- Misjudgements by rating agencies have far-reaching consequences both for economies, in terms of the allocation and availability of capital, and from a microeconomic standpoint with regard to the

¹ In this regard there are currently a number of proposals and initiatives, including from the Bertelsmann-Stiftung (International Non-Profit Credit Rating Agency INCRA) and from the consultancy firm Roland Berger Strategy Consultants a project to establish a foundation-based European rating agency.

possibility and costs of raising capital and the consequences for investment decisions by banks and investors based on incorrect ratings.

- Rating agencies can also exert influence de facto over political decision-making and even whole economies with their country ratings, despite lacking democratic legitimacy.
- Rating agencies thus represent a high systemic risk and must be strictly monitored. The question of the consequences to be borne for wrong decisions, including liability, must also be posed.
- The power of the big rating agencies largely rests on:
 - the prominent role given them by the authorities within the framework of regulation;
 - the “convenience factor” of external ratings for issuers, investors and regulators since it is not necessary to maintain the resources and know-how needed for coming up with ratings in-house, or at least to a lesser degree;
 - the possibility to delegate responsibility for risk evaluations, at least partly; as well as
 - the oligopolistic structure of the rating market.
- Within the framework of the necessary regulation of rating agencies the measures taken or under discussion are largely in the right direction. It is crucial that the European Securities and Markets Authority (ESMA) strictly observes the competences it has acquired.
- Furthermore, it is necessary that central banks make themselves independent of external ratings with regard to the acceptance of securities, at least concerning government bonds, although it would also be desirable concerning company bonds and bonds of financial institutions. The question arises of whether structured products – with the exception of municipal bonds and mortgage bonds – should be fundamentally excluded as security.
- In our view it is necessary to break up the oligopolistic structure of the ratings market. This could be achieved, for example, with the obligation to obtain a further rating which does not come from the “big three”.
- Nevertheless, the medium-term aim of creating a foundation-financed, genuinely independent European rating agency should be pursued. In the short term or alternatively the integration and cooperation of existing “smaller” or regionally active rating agencies can be promoted or rating agencies for certain financial products or groups of issuers can be established.

2 Rating Agencies: The Financial Crisis

Since the so-called Subprime Crisis rating agencies have come under massive criticism. The closing report of the National Commission on the Causes of the Financial and Economic Crisis in the United States declares: “This crisis could not have happened without the rating agencies. ... From 2000 to 2007, Moody’s rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody’s put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded” (The Financial Crisis Inquiry Commission 2011: 25). In particular the last point – late rating downgrades – has contributed to the massive criticism among the public and experts.²

One serious reproach directed against the rating agencies is the commingling of consultancy and issuing of ratings under one roof. This refers in particular to the evaluation of so-called “structured securities” (for example, mortgage-backed securities or MBS). The underlying question of potential complicity between issuer and rating agency cannot be lightly dismissed. There is empirical evidence that issuers with a large number of issues to be valued and thus making large payments to the agencies during the market boom for MBS received better ratings than smaller issuers (see He et al. 2011). Since the beginning of the 1970s it has become usual for issuers of securities to commission rating agencies to evaluate the probability of default of issued securities (solicited ratings) and to pay for it (Issuer-pays model). Previously, rating agencies were mainly commissioned by investors (unsolicited ratings) and paid (Investor pays model).

Payment by issuers harbours fundamental conflicts of interest or the danger of too positive ratings. That applies in particular with regard to – potentially – repeated commissions for ratings rather than single instances. Although evaluations that are systematically too positive would jeopardise the rating agency’s credibility – the rating agencies themselves use this argument to reject any kind of distorted incentive – this barrier does not take effect if (i) all agencies make mistakes systematically or provide too positive ratings and (ii) market participants have no access to other opinions. If, as a result of this conflict of interest, credit ratings are generally distorted upwards the efficiency advantage of rating agencies for the capital markets is at least partly lost because capital allocation takes place on the basis of false information.

With regard to repeated commissions for ratings it is worth looking at empirical studies. It appears that tranches of larger issuers exhibit a lower credit quality than comparable tranches of smaller issuers (see He et al. 2011). The study in question comes to the conclusion that one possible explanation for this is the negotiating power of larger issuers with regard to the rating agencies (see He et al. 2011). Independently of this study the abovementioned Financial Crisis Inquiry Commission came to an analogous conclusion: “You will also read about ... the pressure from financial firms that paid for the ratings, the relentless drive for market share, the lack of resources to do the job despite record profits” (Financial Crisis Inquiry Commission 2011). Thus the Commission raises the question of whether the rating agencies have the necessary expertise or resources to evaluate the relevant financial products that is commensurate with

² This applies even more since as early as 2005 payment defaults with regard to real estate financing were on the increase. Fitch Ratings itself reported this (see The Financial Crisis Inquiry Commission 2011: 18).

the risks involved. Given the abovementioned figure of 30 AAA ratings every working day this question cannot be neglected.

Another reproach directed against the rating agencies is that their activities exacerbated the crisis. Specifically, this reproach is attached to the downgrading of countries in the Euro area despite new or expanded instruments to combat the crisis and manifest austerity measures. This is illustrated by the following press extract: “The aforementioned rating agencies have repeatedly tried, through their inconsistent behaviour, to disrupt reform processes in the Eurozone, often with success” (Hackhausen 2012). The established agencies, both at the beginning of the financial crisis – that is, the Subprime Crisis – and later in the public debt crisis of a number of countries in the Euro area, reacted very late but drastically.³ Through the existing synchronisation of risk evaluation and its abrupt behaviour the rating agencies have functioned as a fire accelerant, giving these subcrises a systemic component.⁴ The impression was that sometimes the rating agencies merely react to shifts in market sentiment. Such late, but drastic rating adjustments that follow not so much actual events as general perceptions consolidate pessimistic expectations on the market, leading to self-fulfilling prophecies and panic-driven market upheavals.

In connection with the deterioration of ratings for European states and the European Financial Stability Facility (EFSF) it has frequently been observed that the rating agencies, because of their location in the United States, are more critical of European countries in their ratings than of US debtors. The issue was vividly captured by the suggestion that the rating agencies might be considered to be an “extended arm of US imperialism” (Hackhausen 2012). A number of considerations run counter to this thesis, however: first, with around 60 per cent of the shares French company Fimalac is the main owner of one of the big three rating agencies (Fitch Ratings) and second, the owners of the two other big rating agencies are in the private sector. Finally, the United States itself has experienced a rating downgrade. Thus some of the abovementioned accusations are not as straightforward as they might seem. Nevertheless, the fact remains that despite the creation of the temporary European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM) Ireland, Italy, Portugal and Spain have been downgraded several times. By contrast Fitch downgraded Minnesota at the beginning of July 2011 only from AAA to AA+, although this US state was de facto insolvent: agreement on a budget was not in prospect and the authorities had to suspend services. In comparison to the Subprime Crisis it can at least be asked whether the comparatively “vigorous” approach to downgrading can at least partly be traced back to the accusations that the international rating agencies responded too late.

Nevertheless, rating changes institutionally can exacerbate crises. In the case of so-called “trigger events” this can, for example, lead to forced sales by fund managers. In addition, rating downgrades can lead to the tightening up of credit conditions or terms. With regard to credit derivatives additional

3 This behaviour appears to be systematic. It manifests itself not only with regard to subprime securities or the insolvency of Lehman Brothers (“A” on 12 September 2008 and “D” on 16 September 2008), but also the financial crises in Asia, Mexico and Russia in the 1990s, not to mention the undesirable developments at Enron or Worldcom.

4 Thus the massive and broad-based downgrading of securities tranches caused the existing information architecture to collapse, which as a consequence put the securities markets into a state of illiquidity. On the role of ratings as a factor of systemic risk see Krahen 2009a and 2009b.

security payments are possible within the framework of “collateral calls”, extending to the triggering of payment obligations in the case of credit default swaps if a rating agency identifies a default. In this connection, however, one might ask whether the rating itself is problematic or the institutional anchoring of this rating in the relevant contract terms.⁵

⁵ This should not, however, reduce the significance of the question of whether the rating models and processes are adequate to provide sustainable ratings.

Rating Agencies: Need and Market Structure

3

3.1 Need for Independent Ratings

Theoretically, rating agencies perform an important economic function by improving and centralising the availability of information and thus reducing complexity. This diminishes information asymmetries and promotes efficient capital markets. The availability of information is improved primarily by the fact that the rating agencies in general do not gather only publically available information, but also have privileged access to extensive private information, for example, from bilateral talks with issuers. This applies in particular to the evaluation of complex structured products. With regard to states, by contrast, the key economic and political parameters are widely known. The question can thus be asked, whether the rating agencies really know more or whether they merely report what is public knowledge.

The need for independent ratings is thus the result of various interests: for example, investors often give fund managers minimum ratings with a view to limiting the credit risk of the investment. Minimum ratings, for example, in relation to repurchase agreements (repos) with the European Central Bank are analogous, as is banks' management of loan portfolios. On one hand, portfolio risks are supposed to be limited by the issue of a minimum rating and on the other hand ratings may serve as a basis for the pricing of credit exposure.⁶

While in the first case the need for independent ratings is immediately obvious since the rating limits the fund manager's freedom of action, in the case of the management of banks the question arises of whether banks (should) have sufficient expertise to carry out rating evaluations of their own. This is even more pertinent because the German banking supervision has long called for this.⁷ Nevertheless, the Financial Stability Board had occasion to make the following demand: "Banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA (Credit Rating Agency) ratings" (FSB 2010: 2).

Obviously, relying on external ratings is at least partially still relevant. The prudential (regulatory) capital adequacy requirement to cover loans with their own equity partly follows the judgement of the rating agencies. The consequence of this is that the relevant credit institutions, if need be, besides their own credit assessment, also (have to) resort to external ratings.⁸ In this case the rating can be interpreted as not merely an "expression of opinion" (largely without incurring liability). The "opinion" has a direct influence on capital adequacy.

It is questionable whether a complete switch to internal risk assessments would result in better risk evaluation. There are certainly critical voices on this point: "The problem with these internal ratings is that the cooks typically fall in love with their own meals. Lehman Brothers allegedly had highly developed internal evaluation methods. They proved to be entirely inadequate, however" (Sean Egan, FAZ 2012). If, however, one considers traditional house bank relationships the question is more than permissible whether the house bank has more, more timely and qualitatively better information about a debtor than an international rating agency. Furthermore, it remains at least open whether the rating model of the

⁶ On this see Section 3.6, The Added Value of Ratings.

⁷ See MaRisk, BTO 1.4, Tz. 1.

⁸ On this see Section 3.3 Ratings in the Legal Regulation of Banks.

international rating agencies is appropriate for giving a precise picture of regionally varying kinds of enterprise financing.

Finally, from the standpoint of the issuer (debtor) it should be noted that an external rating can be an entry requirement for the money and capital markets. We look at this in the following section. Regardless of its capital market access, however, it is in the interest of the debtor to obtain an assessment of the risk situation of his venture or business model by an independent agency.

3.2 Application of External Ratings in Raising Capital

The abovementioned cases – minimum ratings for investments by investment funds, pension funds and insurance companies or for repos – are simple examples of the application of external ratings. Debtors or issues without external ratings for this kind of transaction are not questioned, or only to a limited extent, and are thus favoured in relation to other debtors. Loans without external ratings may also be allocated higher regulatory capital requirements so that the attractiveness of such requirements can fall in comparison to loans provided with external ratings.

With regard to banks it is also conceivable that the relevant institutions do not – or only partly – have the necessary processes and instruments at their disposal to carry out their own risk assessment. For example, the Financial Stability Board demands with regard to smaller banks: “Smaller, less sophisticated banks may not have the resources to conduct internal credit assessments for all their investments, but still should not mechanistically rely on CRA ratings and should publicly disclose their credit assessment approach” (FSB 2010: 5).

On one hand, it is thus imaginable that raising capital without external rating is not possible, while on the other hand it can at least be assumed that a missing external rating *ceteris paribus* will lead to worse financing conditions.

Rating agencies thus influence investment decisions through their assessments. They thus play not only a central but also a decisive role in capital allocation. In connection with this the question arises of who has legitimised the rating agencies or whether their presumed information advantage justifies such an allocation function in terms of economic theory. Answering this question goes beyond the scope of this paper, however.

3.3 Ratings in the Legal Regulation of Banks

The prominent position in particular of the big three international agencies and the high level of penetration and uncritical acceptance of external ratings are encouraged by the regulatory embedding of these ratings by the regulatory authorities.

This lends the rating agencies the appearance of irrefutable objectivity and this promotes their uncritical acceptance. Furthermore, the embedding of external ratings in the investment rules of institutional investors harbours the potential that – strong and sudden – changes in ratings can trigger dramatic price movements because if certain thresholds are “breached” massive sell orders can be triggered or forced. In general, as things stand changes in ratings can sometimes lead to systemically threatening herd behaviour.

With regard to Germany the need within ratings for banks arises from the Solvency Ordinance (SolvV). Banks have the choice of determining capital requirements for credit risks “either according to the credit

risk standard approach (KSA) or the internal ratings-based approach (IRBA)”.⁹ The internal ratings-based approaches (models) require the approval of the Federal Financial Supervisory Authority (BaFin). In this “a distinction must be made between examination for authorisation of the financial institute to use the IRBA and examination of the suitability of individual rating systems” (BaFin 2007: 2). Within the framework of the so-called IRBA suitability tests among other things the suitability of the models for determining minimum capital requirements and preparations of the respective institution with regard to the implementation of stress tests and validation of models by the banking supervision are assessed.

The organisational and technical requirements with regard to the introduction and use of an internal approach must thus be categorised as high. Correspondingly, representatives of the cooperative banks declared: “The costs of implementing, running and guaranteeing the IRB approach would at present be unreasonably high for small banks and would not be balanced by a possible reduction in capital requirements” (Ferry 2005: 8). For the savings bank sector at the level of individual savings banks obviously something similar applies: “We are the central association of 465 local savings banks, none of which could develop an IRB system that satisfies the minimum criterion of the IRB approach” (Ferry 2005: 9). Internal models will thus primarily be established by larger credit institutions (see IFD 2010: 25).

Smaller banks thus often use the standard approach to credit risk. The amount of own funds needed in accordance with this approach depends in a number of cases on external ratings. The risk weights for equity capital of zero, 10, 20, 50, 100, 150, 350 or 1250 per cent determined by external ratings depend on the kind of asset class. In the relevant cases thus the external ratings have a direct influence on the amount of equity capital to be provided by the bank and indirect influence on the interest rate condition.¹⁰ Ratings in this instance thus have a real world implication. For the banks concerned in the final analysis a dependency on external ratings arises so that a direct abandonment of these ratings is impossible. However, the expenditure arising in the case of such an abandonment is to be weighed against the disadvantages described in this paper, in particular the emerging power of the rating agencies.

3.4 The Business Segment of the Rating Agencies

The business segment of the big rating agencies is not limited to the mere issue of credit evaluations. With reference to Standard and Poor’s other business segments can be easily described: Standard and Poor’s, on one hand, functions as a provider of significant (stock) market indices and, on the other, provides studies on both individual companies and markets or defined market segments. Furthermore, the agency assesses the management of investment funds and offers risk measuring procedures and methods for evaluating individual securities. The rating of issuers, states and individual issues is formally independent of these fields of activity.¹¹

Naturally, with other priorities and areas of activity the other two big rating agencies offer a range of services, of which rating is only one. The three big agencies all now have Codes of Conduct – or something similar – to avoid conflicts of interest between business sectors. To this extent, one of the main criticisms of the rating agencies – the combination of rating activities and corresponding requirements of neutrality on the part of the appraiser and profit-oriented consultancy – is invalid. However, it remains to be seen whether these behavioural guidelines have the desired effect.

9 §8 para 1 SolvV.

10 On this see Section: 3.6 The Added Value of Ratings.

11 An overview of this activity profile is provided by Standard & Poor’s homepage: www.standardandpoors.com/home/en/eu.

In any case, the criticism of payment for ratings remains. As long as the company to be evaluated itself pays the cost of the rating there is a potential conflict of interest, for example, of the kind witnessed in the Subprime Crisis.¹² Both conflicts of interest – in other words, those arising from various business segments and resulting from the *payment model* – form the basis of some reflections on the creation of a new rating institution and on the regulation of rating agencies (see, for example, RBSC 2011: 4).¹³

3.5 The Oligopoly of the “Big Three”

Let us take another look at the market position of the “big three” from a regulatory standpoint. The basis for this, in turn, is the Solvency Regulation: with regard to the risk weighting – in other words, banks’ capital adequacy – the following rating agencies were recognised in 2011 in accordance with §§52 and 53 SolvV (sometimes depending on market segment):

- Creditreform Rating AG,
- DBRS,
- Euler Hermes Rating GmbH,
- Japan Credit Rating Agency Ltd.,
- Fitch Ratings,
- The McGraw-Hill Companies operating as “Standard & Poor’s Ratings Services” and
- Moody’s Investors Service (see BaFin 2011).¹⁴

Among other things, the “big three” are thus, from the perspective of the application of risk weightings, recognised for supervisory purposes. The same applies to the United States, where the rating agencies are state recognised credit bureaus (see BaFin 2011). Internationally, the ratings market is dominated by these three agencies (see Handelsblatt 2011).

“Big Three”	World market share (total ca. 5 billion USD)	Turnover	Profit	Number of employees
Standard & Poor’s	47 %	1.7 billion USD	0.88 billion USD	10,000
Moody’s	32 %	2.03 billion USD	0.77 billion USD	4,500
Fitch	16 %	0.83 billion. USD	0.17 billion USD	2,997

The real-economy effects of rating evaluations thus depends, on one hand, on the market penetration of the “big three” and, on the other hand, on the degree of utilisation of ratings, for example, by lending

12 On this see Section: 2. Rating Agencies: The Financial Crisis and Section 4: Rating Agencies: Regulation and Regulatory Proposals.

13 On this see Section: 4. Rating Agencies: Regulation and Regulatory Proposals.

14 A summary of the rating agencies registered in accordance with Regulation (EC) No. 1060/2009 of the European Parliament and the Council of 16 September 2009 on rating agencies is to be found in ESMA 2012.

banks and investors.¹⁵ We have already described typical banks that rely on external ratings in order to determine the capital adequacy required by law. Based on the structure of the banking market in Germany this may apply to a large number of smaller and medium-sized banks. In what follows we shall look at the market penetration of the “big three”.

In 2007, analysts assumed that Standard and Poor’s and Moody’s Investors Service together had a market share of around 80 per cent. This figure rose to around 95 per cent if Fitch Ratings was included (see Economist 2007). It must be noted that these shares are not related to a precisely defined market. Although we are dealing with the world market it is not entirely clear which business segments of the rating agencies were included (see Hackhausen 2012). For that reason, here we shall look at both qualitative assessments and absolute statements by the agencies themselves. Market position, at the time market shares were published, was described as follows: “The big rating agencies are as close to Shangri-La as you can get, at Microsoft-plus margins, ... They wield great power – a downgrade can tip a company into bankruptcy – but lack accountability” (Economist 2007).

The rating agencies themselves describe their scope of activities with regard to the business sector “rating” in terms of impressively high figures: “In 2010 S&P issued 162,418 new and 556,872 revised ratings” (Standard & Poor’s 2012). Moody’s Investors Service declares “Ratings on over 170,000 corporate, government and structured finance securities” (Moody’s Investors Service 2012a). With regard to credit analysis Moody’s Investors Service says: “Our credit opinions cover the debt of approximately 12,000 corporations, 25,000 local and state governments, 110 sovereign nations and 16,000 structured finance transactions, as of December 31, 2009” (Moody’s Investors Service 2012b). The figures of Fitch Ratings are comparatively smaller, but by no means insignificant: “Credit analysis conducted for our Financial Institutions sector provides insightful and comprehensive ratings on more than 3,500 banks and 120 covered bonds around the world... Fitch Ratings’ sovereign team is dedicated to providing timely and objective ratings and insightful research on the foreign and local debt issuance of over 100 countries” (Fitch Ratings 2012).

Although it is not possible to describe market shares without a clear definition of the relevant market – for example, we can assume that the share of the “big three” with regard to German small and medium-sized enterprises (SMEs) is lower than in the case of international capital-market oriented companies – the absolute figures are impressive confirmation of the market position of the “big three”. The strongly oligopolistic market structure in the rating segment – thus the lack of equally recognised alternative providers or plurality of opinions – thus generates, on one hand, great (political) power on the part of the agencies and, on the other hand, ratings decisions can trigger strong market movements. Such synchronisation of risk assessment by a few actors is cause for concern: there is a potential danger that because of the lack of plurality of risk assessment, herd-like developments and corresponding volatility could be provoked, as well as an “investor strike” could be induced by the rating agencies. In this context, there is also the danger of market abuse by the agencies themselves. The latter has additional weight because Standard & Poor’s and Moody’s Investors Service are partly controlled by the same investor groups.¹⁶

15 Besides the level of utilisation what is decisive is whether the rating provides supplementary information within the framework of credit assessment or is also used as the basis of risk weighting.

16 That is, the overlap with regard to shareholders is 38 per cent with regard to Standard & Poor’s and McGraw-Hill and 53 percent with regard to Moody’s (Krall, M., Roland Berger Strategy Consultants 2012: Deficiencies of the Rating Industry, Vorschlag zur Gründung einer Europäischen Ratingagentur, presentation material, p. 9, mimeo).

Furthermore, given the number of providers monopoly rents arise, which other market participants have to bear and, from the perspective of welfare economics, are to be considered negative. By downgrading country ratings rating agencies also decisively influence the financial viability of these countries, as well as their credit and insurance systems. The agencies could thus be the catalysts of a country's insolvency and the collapse of its financial system. This is problematic enough. But it is even more serious if specific European structures or characteristics are not taken into account.

3.6 The Added Value of Ratings

With regard to the financial system a clear distinction must be drawn between risk assessment procedures and procedures for determining a "fair" price.¹⁷ If the pricing model relies on ratings as (sole) input variables the link between rating and pricing is clear. This link intensifies particularly if rating agencies in their assessment rely on the development of or changes in risk margins (for example, CDS spreads¹⁸) of issuers.

Empirical research, however, raises doubts about whether rating classes really represent additional information as against other publically available data, such as balance sheet indicators. It is also questionable, in the final analysis, what risk is really described by ratings. At least one study comes to the conclusion that ratings represent the market-wide so-called systemic risk much better than the rated company's specific risk (so-called idiosyncratic risk) (see Hilscher/Wilson 2011). But while systemic risk can be distributed by an informed investor by diversifying his portfolio, idiosyncratic risk remains. Knowledge about this is decisive for the assessment of information, but is obviously not – or only partly – described by the rating. If investors rely on ratings in their investment decisions, however, there is a danger of a misallocation of capital. This applies both to the investors' standpoint and the market.

Besides these economic considerations there may also be independent costs arising from regulatory requirements with regard to capital adequacy.¹⁹ The tied-up equity capital usually has a yield requirement. From the regulatory standpoint there thus arises a link between rating and price. This raises the question of whether the external rating has added value in comparison to an internal risk assessment. The interdependence with the business analysis is unclear, to say the least.²⁰ But also from a regulatory standpoint there is thus a danger of a misallocation of risk capital.

17 For example, with reference to Jarrow et al.: "For pricing purposes, it is necessary to use the ›risk-neutral‹ probabilities. For risk management purposes, however, it is necessary to use both the ›risk-neutral‹ and the empirical probabilities" (Jarrow et al. 1997: 484).

18 CDS spreads designate the price of credit default swap, usually given in basis points: "With the conclusion of a credit default swap the collateral provider undertakes, for a premium (CDS spread or CDS premium), to compensate the collateral taker on the occurrence of a previously specified credit event (for example, payment default). The level of the CDS premium depends primarily on the creditworthiness of the reference borrower, the definition of the credit event and the duration of the contract" (see Bundesbank Glossary: Kreditausfallswap, www.bundesbank.de/Redaktion/DE/Glossareintraege/K/kreditausfallswap.html).

19 On this see Section: 3.3 Ratings in the Statutory Regulation of Banks.

20 Take, for example, the regulatory risk weighting of government bonds in the Euro Area, quoted at zero per cent. The traded risk premia clearly do not correspond to this risk weighting.

Rating Agencies and Regulatory Proposals

4

With regard to criticisms of the rating agencies as contributors and catalysts of the financial crisis, as well as in line with the G20 decision to subject all financial market participants to adequate regulation and supervision, the European Commission rapidly took up the issue. Banning rating agencies – which has been discussed in some quarters in response to the weaknesses that have emerged in the ratings market²¹ – was never an option. It was neither sensible nor feasible: the capital markets need information-gathering bodies for the assessment of creditors' probability of repayment – only in this way can information asymmetries be remedied. A ban would run counter to the efficient functioning of the market. It could also be expected that other forms/service providers of credit rating would develop. The consensus was thus that rating agencies, on account of their enormous importance for the stability of financial markets, should be subject to effective supervision.

4.1 Rating Regulation 2009

The European Council and the European Parliament adopted a (first) Regulation on credit rating agencies (CRA 1).²² This was preceded by preliminary work by the Committee of European Securities Regulators (CESR) and the European Commission. The main objectives were: to improve the integrity, quality and transparency of ratings; to introduce supervision over rating agencies and a registration obligation for rating agencies. In the event of non-compliance with regulatory requirements the regulators have extensive sanctions at their disposal, including revocation of registration or a temporary ban on doing business.

We shall now look at the main contents of the Regulation.

4.1.1 Registration Obligation

All rating agencies active in the EU must undergo a registration procedure, which imposes certain requirements on the organisation of agencies and the quality of the rating process. Approval is granted initially – on the basis of the CESR guidelines – by the national regulatory authorities in cooperation with the colleges of supervisors. Since July 2011 ESMA has been responsible for registration.

For supervisory purposes – for example, capital adequacy requirements – credit institutions, insurers and so on can only use the ratings of registered/certified agencies. Ratings by agencies not subject to the Regulation – ratings from third countries – can be used for supervisory purposes only under certain conditions. Ratings of unregistered agencies or non-recognised ratings from third countries cannot be used for supervisory purposes.

After the expiry of a transitional regulation the provisions came into full force from 7 June 2011. Without the relevant registration ratings could be used for supervisory purposes only for three, or a maximum of six months. ESMA extended the transitional period several times, eventually to 30 April 2012.

21 See, for example, Heiner Flassbeck, Chief Economist of the United Nations Conference on Trade and Development – UNCTAD.

22 Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

The reason for this is that the registration procedures of the European affiliates of the three major US rating agencies were protracted and only concluded at the end of October 2011. To date, 31 agencies have passed through the registration process (some belonging to the same group).²³

In relation to Japan the European Commission established regulatory equivalence with regard to rating agencies in September 2010, with binding effect. This means that ratings by agencies located in Japan can be used directly for regulatory purposes by financial institutions in the EU. With regard to Australia (December 2011), the United States (March 2012), Canada (March 2012), Hong Kong (March 2012), Singapore (March 2012), Argentina (April 2012), Mexico (April 2012) and Brazil (April 2012) ESMA has classified the regulation of rating agencies there as “as stringent as” European regulation. Accordingly, ratings by agencies resident there can be used for regulatory purposes in the EU even after the expiry of the transitional period in April 2012. A decision on equivalence by the European Commission – as in the case of Japan – is still pending.

4.1.2 Prevention of or Adequate Handling of Conflicts of Interest

With regard to dealing with conflicts of interest the following aspects are addressed:

- consultancy and rating may not be offered at the same time;
- the establishment of an internal control system to examine the quality of ratings and a compliance office;
- provisions on the appointment and emoluments of the administrative or supervisory board;
- regular rotation of analysts and members of the rating committee to avoid too close a “proximity” to the issuers to be evaluated. Similarly, an analyst may not assess a company in which he or she has a proprietary interest.

4.1.3 Improvement of Transparency

To improve transparency the rating Regulation of 2009 provides for the following obligations:

- publication of an annual transparency report;
- publication of the methods, models and key assumptions on which a rating is based;
- for a financial instrument a rating may be carried out only if the underlying data are of sufficient quality;
- the regulators shall maintain a list with information on the past performance of rating agencies.

23 As of the beginning of October 2012 the following agencies were registered and approved in the EU (listing by date of certification [country of registration]): Euler Hermes Rating GmbH (DE), Japan Credit Rating Agency Ltd. (Japan), Feri EuroRating Services AG (DE), Bulgarian Credit Rating Agency AD (BG), Creditreform Rating AG (DE), Scope Credit Rating GmbH / PSR Rating GmbH (DE), ICAP Group SA (GR), GBB-Rating Gesellschaft für Bonitätsbeurteilung mbH (DE), ASSEKURATA Assekuranz Rating-Agentur GmbH (DE), Companhia Portuguesa de Rating S.A. (PT), AM Best Europe-Rating Services Ltd. [AMBERS] (UK), DBRS Ratings Limited (UK), Fitch France S.A.S. (FR), Fitch Deutschland GmbH (DE), Fitch Italia S.p.A. (IT), Fitch Polska S.A. (Polen), Fitch Ratings España S.A.U. (ES), Fitch Ratings Limited (UK), Fitch Ratings CIS Limited (UK), Moody’s Investors Service Cyprus Ltd (CY), Moody’s France S.A.S. (FR), Moody’s Deutschland GmbH (DE), Moody’s Italia S.r.l. (IT), Moody’s Investors Service España S.A. (ES), Moody’s Investors Service Ltd (UK), Standard & Poor’s Credit Market Services France S.A.S. (FR), Standard & Poor’s Credit Market Services Italy S.r.l.(IT), Standard & Poor’s Credit Market Services Europe Limited (UK), CRIF S.p.A.n (IT), Capital Intelligence (Cyprus) Ltd (CY), European Rating Agency, a.s. (SK), Axesor SA (ES).

4.1.4 Structured Financial Products

Ratings for structured financial products need to be visually distinguished from other ratings.

4.2 Revision of the EU Rating Regulation 2010

In 2010 preliminary work was carried out on the first revision of the Regulation (CRA 2). This came into force in May 2011.²⁴ In accordance with it responsibility for the supervision of rating agencies passed to ESMA, although it can delegate tasks to national supervisory authorities. ESMA is granted a number of powers in its supervisory activities: for example, it can demand the submission of documents and data, summon and question people, carry out on-site inspections and impose administrative penalties and fines.

Furthermore, the aim is to increase transparency with regard to structured financial products: issuers of structured financial products are obliged to make available all information it provides to the agency it commissions to prepare a rating to all other registered rating agencies. The background to this is to give all registered rating agencies the possibility to prepare so-called unsolicited ratings on the basis of adequate information.

4.3 Commission Proposals on the Revision of the Regulation on Rating Agencies of November 2011

Despite the rating Regulation a number of problems remained:

- oligopolistic market structures;
- “rating credibility” or the de facto sovereign dominance of the rating agencies;
- lack of rules on liability (beyond simple negligence);
- inadequate regulations on the timing of rating decision-making and thus the danger of panic-driven market developments as a consequence of “surprising” and significant downgrades.

In November 2010 the European Commission launched a consultation for a further revision of the EU rating Regulation and held a roundtable on the subject in July 2011. The issues addressed were: reducing reference to ratings; new rules on ratings of government bonds (in particular, longer periods of notice for ratings adjustments); strengthening of competition among rating agencies; introduction of civil liability rules; reduction of conflicts of interest on the basis of the Issuer-Pays model.

In June 2011 the European Parliament adopted an initiative report or non-legislative resolution on the further regulation of rating agencies – with reference to the Commission consultation – and also declared itself in favour of establishing a European agency (in the legal form of foundation and with state start-up financing).²⁵ The following points were highlighted in the resolution:

²⁴ Regulation (EU) No. 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No. 1060/2009 on credit rating agencies.

²⁵ European Parliament resolution of 8 June 2011 on credit rating agencies: future perspectives (2010/2302(INI)).

- Reduction of the excessive dependence of the regulatory system on external credit ratings within a realistic period.
- Examination of the use of external ratings in establishing eligible assets.
- Strengthening of risk evaluation or increased use of the IRB approach.
- Improvement of access to important credit-related information.
- Expanding the capacity of supervisory bodies with regard to the monitoring of increased use of internal credit risk evaluations.
- For all external credit ratings used for regulatory purposes two ratings should be compulsory and, where appropriate, the less favourable should be used. For the first rating, the issuer should decide which agency to commission, while the second rating should be commissioned by ESMA.
- Suggestion to introduce a European rating index (EURIX) which summarises all the ratings of registered rating agencies available on the market.
- Civil liability of rating agencies in the case of gross negligence or impropriety should be established on a uniform basis throughout the EU.
- Request to the Commission for proposals for alternative payment models.
- Request to the Commission concerning an impact assessment and feasibility study for an independent European rating foundation.
- Request to the Commission concerning the examination of support for developing a network of European rating agencies.

In November 2011 the European Commission accepted a proposal to revise the existing Regulation (CRA 3).²⁶ The Commission's objective is to rectify the defects in the existing Regulation. In particular, excessive reliance on ratings is to be reduced, rating procedures qualitatively improved and more competition cultivated among rating providers.

4.3.1 Reducing Overreliance

The Commission notes that ratings now play a quasi-institutional role and it would like to reduce reliance on them.²⁷ The Commission notes that because of the proposals on the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR) there is less reference to external ratings and the financial institutions have to carry out their own evaluations with the required diligence. With regard to

26 COM 2011/746 (Richtlinie amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings) and COM 747 (Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies).

27 These considerations are in basic agreement with the proposals of the Financial Stability Board. In order to reduce the prominent position of the rating agencies the FSB has discussed various measures: medium-term reduction of the "institutionalisation" with regard to supervisory purposes of the assessments of various rating agencies; strengthening of banks' internal evaluation systems; restriction of reference to ratings in contracts; extension of the information obligations of issuers of securities in order to enable market participants to carry out better risk assessments of their own (for details see FSB 2010).

the provisions on fund managers the Commission has proposed similar amendments. The package is likely to be rounded off with the amendment of provisions for insurance companies.

The Commission has thus chosen the path of reducing regulatory resort to external ratings rather than completely banning them. And in fact the most obvious solution of banning external ratings from regulatory provisions completely and compelling institutional financial market actors to exclusively use their own credit assessments is not sustainable on closer inspection:

- The financial crisis has revealed grave weaknesses in so-called internal risk assessment models.²⁸ Giving up the standard approach, which is based on external ratings, in favour of the IRB approach, based on internal ratings, would thus be associated with considerable risks to stability.²⁹
- The supervisory authority that inspects and approves the internal assessment model is ultimately responsible. This is neither desired by the supervisory authority itself, nor does it do any good for its reputation – in particular in the case of failure – which thus would weaken its (political) position.

Taking this into account, external ratings cannot be dispensed with regulatory provisions in future. Further regulatory steps concerning the activities of rating agencies – including the methodology of the rating process – are thus essential.

Finally, however, the possibility of setting guidelines for US rating agencies – for the simple reason that the threat of not recognising them for regulatory purposes is not credible in view of the lack of alternative providers – remains limited. Thus alternative (European) providers must be promoted and, if necessary, a new actor established.

In the short term we advocate that decision-making concerning the acceptance of eligible assets in the euro system be completely decoupled from external ratings and instead assigned to internal assessments. This should be the case at least for government bonds, but preferably also corporate bonds and the bonds of financial institutions.

4.3.2 Compulsory Rotation

The European Commission proposes a strict rotation principle for the rating process. In accordance with this after three years the agency must be changed; and if a rating agency evaluates more than 10 debt instruments for an issuer, then after one year. After a “cooling off period” of four years the agency may again be used for an evaluation.

28 As far as internal models are concerned there has long been a suspicion that, on one hand, these models are understood only by their “designers” in the bank and, on the other hand, their calibration is deliberately aimed at freeing up capital. From an academic point of view the problem with internal models is that spreads are assumed that mask so-called “black swan events”. Thus if the present strongly deviates from the future a prognostic problem arises. Not least with regard to the problems outlined here the Basel Committee announced in February 2012 that it was setting up a working group on internal risk models, in particular across countries. It is not yet known when the first results and possible proposals will be available.

29 The standard approach is currently applied above all by small and medium-sized credit institutions. The background to this is the high procedural demands on internal assessment models and the associated high fixed costs. The use of internal rating procedures could thus take place only by means of – group internal – pool solutions, which are possible basically in all three pillars of the German banking sector.

Enforced demand for a larger number of providers, on one hand, should open up the market to competitors and, on the other hand, the rotation principle should avoid possible conflicts of interest due to “continued employment”.

The banking industry has expressed concerns in this connection about higher ratings volatility and the hampering of European issuers on international financial markets due to a shorter and inconsistent rating history. Furthermore, it is pointed out that with regard to rotation the performance of rating agencies cannot be evaluated. While these fears are not to be dismissed out of hand they should be weighed against the opportunity to reinforce competition through a larger number of providers and to give new actors the possibility to build up their reputation.

4.3.3 Harmonised Rating Scale

The European Commission proposes the standardisation and harmonisation of ratings. Underlying this is the idea that even in the case of enforced rotation comparability should be established at least with regard to scaling.

Whether standardisation or harmonisation of the rating scale with regard to different underlying methodologies can be achieved remains questionable, however. In any event, methodologies should not be standardised since otherwise differentiation between agencies would no longer be possible, which would tend to reduce competition.

4.3.4 Ratings for Structured Financial Instruments

The Commission proposal foresees for the issuers of structured financial instruments the obligation to make available extensive information and the obligation to commission at least two agencies, each of which provides its own independent rating.

The obligation to provide information includes information on the credit quality and performance of the individual securities underlying the structured financial instrument, on the structure of the securitisation transaction and on cashflows and all collateral underlying a securitisation. Furthermore, all information necessary to make it possible to carry out comprehensive and well-informed stress tests on cashflows and collateral values behind the underlying receivables must be made available.

4.3.5 Transparency

The Commission proposal envisages that rating agencies must be obliged to publish detailed information – parameters, stress scenarios and so on – and justify changes in the methodology. Similarly, the evaluated actor must be given time and opportunity to identify possible mistakes in the rating and be able to put forward counterarguments. With these measures, on one hand, third parties should be able to judge and appraise the analyses of agencies, while on the other hand, a more intensive dialogue between rating agencies, issuers and investors should arise.

Furthermore, ESMA should evaluate and approve methodologies. Pricing policies and structures should also be supervised.

Measures to increase transparency and quality specifications are undoubtedly sensible in order to counteract tendencies towards herd behaviour and in good time to subject agencies to the critical observation of market participants. However, this should go further than in the Commission proposals:

- transparency obligations should also include disclosure of the composition of the rating committee and the fee structure;
- there should be limits on the number of rating analyses per analyst in order to ensure satisfactory quality for reasons of time alone;
- in addition, all information made available by issuers should be included in the rating process;
- it is also to be considered whether at least one of the analysts should speak the native language of the issuer in order to be able to properly evaluate the information provided.

4.3.6 Country Ratings

The agencies are requested to review country ratings no longer annually but every six months. Furthermore, country ratings should be published only after the close of trading and at least one hour before the opening of trading venues in the EU. Also, new transparency provisions are envisaged for rating agencies, in particular with regard to the employment of staff concerned with the issuance of ratings. The Commission has left open the question of a temporary freezing of country ratings.

The possibility to freeze country ratings temporarily – up to three months – should be followed up, however. This regulation would offer the opportunity to counteract market turbulence, in particular if it consisted of obligations to invest only in certain rating categories. Furthermore, countries would obtain a window of opportunity to take corresponding policy measures. Thus it could be avoided that fiscal consolidation measures coincide directly with downgrades.

4.3.7 Further Supplements

The Commission proposal also includes the following points:

- regulation of the civil liability of rating agencies in the case of wilful intent or gross negligence with regard to the Regulation on rating agencies on the principle of the reversal of the burden of proof;
- limitation of the shareholding of a shareholder or a member of a rating agency in another rating agency to a maximum of 5 per cent;
- creation of a EURIX that brings together all the ratings available on the market and makes them freely accessible.

4.3.8 State of the Legislative Process

The Commission proposal is currently in the ordinary legislative procedure, in other words, in consultations of the European Parliament and the Council. ECOFIN last dealt with the CRA 3 proposal in June, but so far without taking a final position.

The European Parliament's Committee on Economic and Monetary affairs presented its draft report in mid-February 2012 (rapporteur Leonardo Domenici [S&D], shadow rapporteurs include Sven Giegold and Dr Wolf Klinz). This was the basis for further consultations and in mid-June was adopted by ECON. This report was presented to the plenary session of the European Parliament in August and the vote in the plenary session is scheduled for December 2012.

The ECON committee's report criticises in particular that in contrast to what was called for in the motion on a resolution of the Parliament of June 2011 the establishment of a European rating agency is not provided for in the Commission's proposal. Furthermore, the ECON committee calls for, among other things:

- a ban on unsolicited public debt ratings;
- restrictions on mergers or takeovers of rating agencies that have already achieved a considerable volume of turnover with their ratings activities in the European Union;
- a provision that rating agencies may not hold shares or financial interests in evaluated companies.

The ECON committee also proposes to task ESMA with an annual report on the performance of rating agencies as well as to work out proposals on payment models on the basis of which the selection and remuneration of rating agencies are completely independent of the evaluated companies.

Creation of a European Rating Agency: Arguments and Proposals

5

The objective of adequate regulatory dealings with the existing ratings providers has always been only one among several. From the beginning there has been political discussion of how the oligopolistic market structure can be “broken”. Because of the extremely high market entry barriers no change in market structures is to be expected purely on the basis of market processes: new rating agencies lack reputation and acceptance on the investor side, as a result of which issuers are reluctant customers. At the same time, new providers lack a critical mass of the necessary data and teams of analysts, so that they scarcely have the possibility of building up a market position.

Besides the welfare-theoretical advantages of an increase in competition the value of a European agency would be that it could better understand the structure of the European financial sector than other, predominantly Anglo-Saxon institutions. The establishment of a European rating agency could also help to strengthen Europe’s position as a financial centre. If a European agency could be established it would be easier for ESMA to regulate or monitor it, in comparison to the agencies not resident in Europe. This would generally contribute to financial market stability.

However, there have already been various initiatives in the past to establish a European agency, none of which were successful and sometimes failed, at some financial cost.³⁰ The difficulties facing new competitors wishing to obtain a foothold in the international rating sector are illustrated by DBRS: offices were set up in London, Paris and Frankfurt in 2005 but with the outbreak of the financial crisis they had to be closed again. Since 2010 DBRS has been present in Europe (London) once again.

Nevertheless, it is a declared political intention to change existing provider structures. Several approaches are under discussion. Besides support for building up a network of existing small and medium-sized rating agencies consideration is being given to the creation of a new foundation-based rating agency, the European Rating Foundation. The capital would be raised from companies in the financial sector. To bridge the development phase state start-up financing (repayable) is under discussion.

In the debate on structural changes in the rating market there is also a proposal for a European fund solution (Beck/Wienert 2010: 24). This would involve the issuer turning to a yet to be established European fund which, without disclosing the issuer, would commission an agency to carry out the rating by tender. Thus the link between the rating commission and the commissioner would be cut. Discussions are being held about financing such a European fund through contributions from all issuers or investors that use ratings in accordance with statutory regulations.

30 One might mention the initiative by 24 German banks and companies to establish Company Rating mbH, Frankfurt/Main (1991 to 1993).

5.1 Central Bank Ratings as an Alternative Opinion

Within the framework of collateral for refinancing operations – list of eligible collateral – the central banks of the euro system (including the Banque de France, the Bundesbank and the European Central Bank itself) create their own ratings. Publication of these central bank ratings and increasing the scope of assessment – in accordance with a proposal that has arisen in debate – would give the market a further value appraisal and basically function like an additional rating agency. Within the framework of the consultation procedure launched in November 2010, however, the ECB rejected the publication and regulatory application of (internal) central bank ratings (see ECB 2011).

5.2 Credit Insurers as the Nucleus of a New Rating Agency

Since a new market actor needs to build up the requisite database and corresponding algorithms there is a significant lead-time. Thus as an alternative to establishing a completely new rating agency the idea was mooted of encouraging large credit insurers to expand their business.

The established credit insurers, such as Euler Hermes or Coface, already evaluate companies' economic situation and countries' macroeconomic environment in detail. Thus they possess the necessary knowledge, experience and statistical basis to evaluate default probabilities with regard to securities. This – according to a proposal made during the political debate – makes them ideal as a nucleus of a European rating agency – in other words, by expanding their businesses these companies could take on the task of a competing European agency.

The Euler Hermes group would be ideally suited for this. It already has a rating agency, Euler Hermes Rating GmbH. In addition, Euler Hermes Kreditversicherungs AG handles various instruments for export promotion on behalf of the German government, including export credit guarantees (so-called Hermes cover), as well as guarantees for investments abroad to hedge against political risk (so-called investment guarantees).³¹ The Euler Hermes group, because it has its own rating and commercial credit insurance business and handles German government export promotion programmes, possesses experience and reliable data with regard to carrying out country ratings and default risk. Euler Hermes also has the advantage that as an affiliate of Allianz a link could be established with the data and output of another Allianz affiliate, Pacific Investment Management Company (PIMCO). Euler Hermes, however, has rejected initial plans to cooperate with a European rating initiative.

In principle, the credit analysis departments of banks or investment companies could also form a nucleus. They could at least operate as rating providers for certain market segments. Fields of activity could open up here for the regional banks (through the spinning off and merging of the relevant departments). The relevant initiatives have so far not got off the ground, however.

5.3 State European Rating Agency

Occasionally, founding a state European rating agency is considered. A number of problems would arise in this instance, however: ratings of a state agency would be likely to lack credibility and thus accept-

³¹ Investment guarantees are a promotional instrument of the German government for domestic companies to help open up foreign markets through a local presence in the form of their own production and service facilities. They were introduced in 1959. The companies charged with handling the scheme are PricewaterhouseCoopers AG, the audit company, and Euler Hermes Kreditversicherungs AG.

ance, in particular with regard to government securities. In addition, misassessments cannot be avoided in individual instances even in credit assessments by public agencies. In this connection questions of liability arise that ultimately have to be met by the tax payer.

5.4 Foundation-Based European Rating Agency

Also because other approaches lack feasibility the discussion in the political arena and the financial sector is increasingly concentrating on the idea of a foundation-based European rating agency (European Rating Foundation). The foundation's capital would be raised from the financial sector. To overcome market entry barriers – building up a data pool and market knowledge, dealing with unrealised scale effects and product standardisation, overcoming the still lacking distribution depth, as well as acceptance and reputation – (government) start-up financing (perhaps repayable) is necessary.

The idea of a foundation basically ensures the requisite independence. In addition, in order to attain adequate credibility the institutional arrangements must be such that the agency's operational work is completely independent and neutral with regard to the providers of the start-up financing and capital donors. Furthermore, operational work – also in order to achieve rapid acceptance – must have a high degree of transparency, in other words, disclosure of the bases and procedures of judgement.

5.4.1 Ways of Financing a European Rating Agency

In particular during the start-up phase of a new agency external financing will be needed. This is due, in the first instance, to the considerable market entry barriers and correspondingly high launch costs.

Government start-up funding is also justifiable in terms of economic theory, primarily for two reasons:

- Markets with high market entry barriers tend towards monopolistic or oligopolistic provider structures. Because of the low level of competition monopolistic rents arise on the provider side; in addition, the number of transactions tends to be low. The processes of a market economy alone cannot overcome this market imperfection. Market intervention in the form of government subsidy of market entry is necessary to raise the level of competition and thus to realise welfare gains for the economy. A good example is the aircraft construction market: to overcome Boeing's monopoly the EU has long paid market-entry subsidies to Airbus.
- Coupled with an obligation for issuers to make accessible to the European agency all information relevant to producing a rating the European agency must be put in a position to prepare unsolicited and public ratings. Thus it would provide a kind of public good, thus justifying government (start-up) financing in terms of economic theory.³²

With regard to the long-term “payment model” a number of models are conceivable:

- tax financing of ratings;

³² See Mählmann, T. 2010: “If issuers can decide freely about the publication of their ratings and not every issuer has a rating, issuers with a rating can hide behind the possibility of not having a rating. The uncertainty of investors concerning whether individual issuers have a rating ... enables issuers with a rating to successfully conceal unfavourable information in the form of bad ratings ... As a result, their issues will thus be overrated by the market. The issues of issuers without ratings will thus be undervalued.”

- the investor pays: stock exchanges levy an additional fee on issues and pay it to the rating agency (in the event of non-placement the issuer pays);
- institutional investors pay a (annual) fee, based on their investment volume, to an “administrative fund” and security issuers turn to this fund. This commissions ratings and pays the rating agency;
- the issuer pays its chosen agency;
- the issuer pays, but the supervisory authority chooses the agency.

Permanent government financing of ratings – perfectly feasible as a public good – is unrealistic politically. But since ratings have the characteristics of a public good – in other words, they cannot be used purely privately – individual payment by investors is fundamentally problematic. Other solutions, such as the payment of a percentage-based fee related to investment volume, would be too much of a blanket approach. Raising a fee only related to rated assets would – since this as a rule happens with reference to a key date – lead to short-term portfolio switching, which may destabilise the market. Thus, if the investor is to pay directly, payment for ratings per issue would be a better way, even though evasive reactions to stock exchanges not subject to payment of the fee are conceivable.

If issuers pay there are conflicts of interest and thus distorted behaviour on the part of the rating agency cannot be ruled out. However, this can be countered by strict transparency of the rating procedure and the basis of decision-making, as well as the awarding the commission of the rating to a third party.

5.4.2 Measures to Increase (in the Short Term) the Acceptance of a European Rating Agency

In order to facilitate rapid acceptance of a new European agency on the market various regulatory levers and organisational mechanisms can be applied:

- Within the framework of open market transactions the euro system accepts only securities as collateral that (also) have a rating by the European agency.
- In addition, the banking supervisory authorities must disclose the methods used to calculate capital adequacy from counterparty risk for ratings of the European agency.
- At the international level efforts must be made to get the US Securities and Exchange Commission (SEC) to change its rules so that market entry is possible for the new European agency. In particular, the SEC must grant it NRSRO status (Nationally Recognized Statistical Rating Organization).
- All securities issued by market actors from the EU area must – without ruling out other ratings – have a rating by the European agency.
- Alternatively, it can be required that all issuers that have a rating issued for a security also make available the requisite information – including answering possible questions – to the European agency. It is then important to oblige the European rating agency to prepare so-called unsolicited and public ratings, in other words, ratings not commissioned by the issuer, to whose publication the issuer cannot object, since he has no publication rights over them.³³

³³ Since various company data will in this way de facto be made freely available such a procedure is likely to result in issuers or creditors will provide much less information.

Rating Agencies: Summary

6

To evaluate the question concerning the need for and services of rating agencies a number of points of criticism or at least unclarified questions remain. This applies in particular to the aspect of ratings' institutional anchoring. This can be commercial (examples include the investment requirements of investment funds, pension funds and insurance companies or “trigger events” in the case of credit derivatives) or regulatory (in the event of capital requirements with regard to assets). From this standpoint it is not the rating agencies themselves, but the power conferred on them that is to be criticised. However, it is not a straightforward matter to change this since some market participants do not have the expertise and resources needed to be able to do without external ratings.

To that extent the apparently obvious solution of completely banning external ratings from the regulations and obliging credit institutions and other institutional financial market actors to use exclusively their own credit assessments is unsustainable on closer inspection. First, the financial crisis has revealed grave weaknesses in so-called internal risk assessment models. Second, the supervisory authority that inspects the internal assessment model is ultimately responsible. This is neither desired by the supervisory authority itself, nor does it do any good for its reputation – in particular in the case of failure – which thus would weaken its (political) position. Taking this into account, external ratings cannot be dispensed with in regulatory provisions in future. Regulatory steps must therefore be directed in the first instance towards the rating agencies themselves.

Ultimately, the possibility of imposing guidelines on US rating agencies – if only because the threat of not recognising them for regulatory purposes is not credible due to the lack of alternative providers – will remain limited. Thus (European) alternative providers must be promoted and, if necessary, a new actor built up. The creation of a foundation-based European rating agency is an appropriate way of doing this. In addition, coordination and cooperation between existing “smaller” rating agencies should be promoted or rating agencies for certain financial products or categories of issuers built up.

In the short term, decision-making on the acceptance of eligible assets in the euro system should be decoupled from external ratings as far as possible and instead internal assessments should be used.

With regard to potential conflicts of interest within rating agencies limits have been established, at least for various interests in the various business segments of the rating agencies, with corresponding guidelines. The form of payment for ratings, however, continues to represent a conflict of interest, which must be considered a point of criticism. This can be countered by strict transparency of the rating procedure and the basis of decision-making, as well as allocating commissioning of ratings to a third party.

The sometimes indirect link between pricing for loans and rating is to be regarded critically. By analogy with questions about dependence on external ratings it should first be asked whether every investor – in other words, every lending bank – should be in a position to carry out their own analysis of a fair price for a product.³⁴ If this was the case it would reduce dependence on external ratings for individual market participants.

34 Or alternatively, to do without purchasing this product.

The abovementioned points are of a business or regulatory nature. From a macroeconomic perspective the main point of criticism is the oligopolistic structure. Even though other rating agencies exist or are approved by the supervisory authorities, market share in itself should be viewed critically. On this point Schrooten (2011) writes: “In fact, the three mentioned rating agencies have long enjoyed market dominance ... That has long been so and hitherto has troubled few people. But any basic macroeconomics textbook shows that in the case of market power the simple laws of the market economy are cancelled”. From this standpoint, too, the promotion of (European) alternative providers or building up a new actor is to be supported.

From a macroeconomic and business viewpoint the influence of rating agencies on capital allocation is dubious. Misjudgements can have grave macroeconomic and business consequences, such as the evaluation of structured real estate financing in the United States or belated and perhaps dramatic changes in country ratings have demonstrated.

Summarising and with reference to the question of whether rating agencies are necessary, superfluous, a necessary evil or harmful we can say the following.

Rating agencies will continue to find a market for their products, in particular their ratings, as long as banks, insurance companies, funds and investors are subject to a regulatory or self-imposed compulsion to use them or have a need for these ratings, which simplify and support their decision-making.

Because of this and the freedom of global markets bans would be neither sensible nor permissible so that rating agencies must be regarded as necessary in the broadest sense.

On this basis we can conclude, however, that they are not generally necessary and thus in some respects superfluous without this having led to any consequences so far. This is due in particular to the unchangeable power of market participants with regard to which changes are possible only with their consent and cooperation. It would be desirable, however, to more strictly limit the role of external ratings in regulatory questions. The tasks given to rating agencies in this respect should be resumed and carried out by those responsible for this as far as possible.

From a macroeconomic standpoint the oligopolistic structure of the market must be regarded as an “evil”, especially as this leads to excessive market power of the three leading agencies.

Rating agencies cannot and must not disclaim the consequences of their actions. Their misjudgements have contributed to macroeconomic and business upheavals or damage, in particular where external ratings were widely used for regulatory purposes or investment decisions.

In our opinion, rating agencies are of major systemic importance, and in particular have attained influence over entire economies with their assessments. We thus consider intensive supervision of rating agencies and a possible change to the oligopolistic market structure to be absolutely necessary.

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