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Euro Area Sovereign Debt Crisis and Rating Agencies:

NOTE

Abstract

Ratings are a public good, and should therefore be improved, enhanced and globalized. The best solution for the intrinsic problems of Credit Rating Agencies (CRAs) is a correct regulation and supervision. Both should be based on harmonized global standards. In this process the US and Europe should take the lead. A level playing field would help to develop a larger market and creates incentives for more entrants in the present oligopolistic market and could therefore lead ultimately to more competition.

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EXECUTIVE SUMMARY

Credit Rating Agencies (CRAs) were created to mitigate problems of asymmetric information in debt securities markets between debt sellers or issuers and debt buyers or investors. Therefore, they are a public good. When they were being paid by investors they did not have a conflict of interest because their incentives were aligned; since 1972, they started to be paid by issuers and enter into conflicts of interest. CRAs have several other intrinsic problems of market concentration, barriers to entry, liability and others, which have been realized by investors and that should be fully addressed by regulators and supervisors.

Their largest conflict has been in the rating of structured financial products and their different tranches which were critical in unchaining the financial crisis in 2007-2008. In the present sovereign debt crisis their badly timing and sometimes contested sovereign ratings have helped to produced cliff effects and contagion.

Separately, both the US and the EU have increased notably their regulation and supervision of CRAs to reduce their intrinsic problems and align properly their incentives. It would be extremely important to introduce a level playing field and to achieve global standards to achieve a more efficient CRAs system which allows more competition and new entrants to reduce its oligopolistic nature. The ECB is fully supportive of the EU efforts to regulate and supervise CRAs in order to reduce their conflict of interest, their transparency and their efficiency.

The idea of a totally independent European CRA, but publicly sponsored and financed by the European Commission, specialized in sovereign ratings, would most probably fail because investors would become suspect about its true independence. Alternatively, a CRA sponsored by the ECB would be a non starter because the ECB would be rating its own shareholders and because it is beyond its mandate.

1. INTRODUCTION

Credit Rating Agencies (CRAs) have been designed and created to mitigate the large problems of asymmetric information existing in debt securities markets between debt issuers or sellers and debt investors or buyers, in order to avoid finance directors of private companies and/or treasury directors of governments cheating or not providing enough information to investors about the solvency of their debt securities issues.

The main reason why CRAs were created was to allow investors in debt securities to have access to a trusted, independent and credible third party opinion, in order to avoid taking excessive default risks that they were not able to guess directly, as well as to allow them to check if their fund managers were taking excessive risks.

CRAs business models are based on the fact that they are able to pool very large amounts of information about the solvency of debt securities; such information is extremely difficult and expensive to be collected by individual investors, and CRAs are able to give a sound and independent advice service to the latter at a lower alternative cost.

CRAs have been given an even stronger and increasing role by regulators under the Basel II and Basel III agreements, as well as by the European CRD (Capital Requirements Directive), on the basis that they are supposed to produce a “global public good”, given that their ratings are public information which can be eventually used freely by investors, regulators and the public in general.

2. INTRINSIC PROBLEMS WITH CRAS

There are several intrinsic problems with CRAs that tend both to reduce the efficiency and accuracy of their ratings and to produce conflict of interests:

1 - From their start in the 1930s and until 1972, they were paid by investors, which were buying debt securities and taking their risk of default, and, for that reason, they needed an independent and trusted third party rating advisor. Therefore, the largest and most frequent debt investors were subscribing to their rating services to reduce or minimize default risk. This traditional remuneration system was the right one and had the CRAs incentives rightly aligned, although it was somehow creating a "free riding" problem, because their ratings were made public and could be used by non subscribers as well.

Nevertheless, after 1972, they started to be paid by the issuers of debt securities, so that, they engaged in a serious conflict of interest because they were created for the opposite end, that is, to reduce the default risk of debt securities buyers by increasing their information about the risks of each debt security and by diminishing the probabilities of being cheated by their issuers.

2 - Until very recently (Dodd-Frank Act 2010), CRAs were not legally liable for their ratings in case these were proved to be wrong. Unlike auditors, they have achieved legal immunity, when being prosecuted by investors, because they are registered only as "financial journalists" which are protected by the 15 December 1791 First Amendment of the US Constitution, which established several freedoms, under the Bill of Rights, including, freedom of speech and freedom of the press. Therefore, they exclusively were living on their "reputational capital".

By contrast, their income was mainly due to having been able to obtain a license given by the Securities and Exchange Commission (SEC), the US regulator, to become a Nationally Recognized Statistically Rating Organization (NRSRO) which gives them a special and privileged status to conduct their business, which becomes oligopolistic by nature. Therefore, they are an oligopoly blessed by the market regulatory authorities and, at the same time, they could not be taken to court if they were wrong in guessing the probability of default of their rated debt securities.

3 - There are very few CRAs because: first, there are large barriers to entry in their market, given that it is very difficult to become a NRSRO; second, their network externalities are very large and third, the efficiency argument enhances their concentration because it is the way to avoid duplicating the large effort by issuers to generate information that becomes free of access to others and the public in general (you may consider to make clearer this last sentence).

Some economists believe that there is a de facto duopoly, because the two largest have 80% of the market and the third one another 18%, and there are another 150 smaller CRAs in the world. In that case, it would be better if this duopoly became a monopoly, because issuers would not be able to go from one CRA to another pitching for a better rating as they do now (Bolton, Freixas and Shapiro (2009)).

4 - This latter problem is derived from the conflict of interest of the different users of ratings, which tend to have diverging interests. Regulators and debt securities investors want a high quality rating in terms of research and analysis, which should be strict, independent and unbiased. Debt issuers, by contrast tend always to prefer more "favourable" ratings. As they are those which pay the CRAs, the latter become suspect of

having a clear incentive to tend to be less strict with their ratings in order to get more business from the former.

5 - CRAs, in order to perform their job, use not only public information, but also private information, which is not available to the public, which they obtain from their interviews and contacts with the top executives of their issuing clients. This “privileged, non public, information” could be used later to sell to the issuers other kind of related advisory services (Mariano, 2009)

6 - Although their price structure is well known and oversee by their regulators, they tend to bargain prices with their more regular clients for the following reasons: First, the issuer only pays the CRA if its debt security is issued with its given rating. Second, as the CRA gives its client a provisional rating, the issuer can have an incentive to turn it down, go to another CRA and try to get a higher rating. Third, the issuer can try, before going to another CRA, to bargain the rating with the first CRA in exchange of promising it more business.

7 - During the financial crisis, some CRA were suspect to have sold to the issuers consulting and advisory services as of how they should structure their CDOs and their respective tranches by using complex mathematical models, which could make them more efficient, less prone to default and, therefore, able to receive a better rating, which was given eventually by themselves.

8 - Some economists think that, in the case of complex structured products, the amount of information given by the issuers to the CRAs and by these to the final investors was very low, because issuers thought that it was better for them to give less information to all investors than to give more information only to the sophisticated investors, which would understand it better. In that way, they were convincing the less sophisticated investors that they were not going to lose more than the sophisticated ones or that the latter were not going to win more at their expense (Pagano and Volpin, 2009).

9 - Ratings tend to be pro-cyclical. Their relative changes, that is, their increases minus their decreases, tend to show a large pro-cyclicality. Therefore, they cannot be efficient at the time of preventing or avoiding large swings in financial markets prices because they tend to enlarge them, provoking uncertainty and “herd behaviour” among investors (Amato and Furfine, 2003). They also tend to provoke “cliff effects” where a downgrade of a single debt security can amplify pro-cyclicality and can cause cascading effects and contagion on other securities, as it has been happening during the euro area sovereign debt crisis.

10 - Ratings tend to be retrospective instead of forward looking. Moody’s did not realize that Lehman could default and only reduced its rating four days before it defaulted and S&P reduced Lehman rating the same day of its default, creating a huge loss of confidence in their ratings, herd behaviour and contagion. Something similar happened to AIG and Washington Mutual ratings.

11 - CRAs only rate debt securities’ probability of default, recovery in case of default and correlation of defaults (for investments with multiple assets) but not their market and liquidity risks which also affect decisively their risk of solvency and default. They were using the same rating methodologies for highly rated debt securities issued by sovereigns, which were traded massively everyday in regulated exchanges with a high level of liquidity, as for tranches of CDOs which were only sold and bought bilaterally between unknown buyers and sellers in illiquid “over the counter” exchanges.

12 - CRAs ratings methodologies are difficult to understand, given that are based on probabilities of default of a debt security and only on its relative probability of default in relation to other debt securities of the same or similar issuers, not providing numerical estimates of default of each security.

As a result of these 12 intrinsic issues, CRAs ratings of “structured financial securities” such as CDOs and CLOs and their tranches were abnormally high and prone to failure. As a consequence, structured securities tranches rated AAA came down from a value of 100, in August 2007 to 23, in December 2008 and those rated AA came down from a value of 100, in 2007 to only 4, in 2008, generating a huge lack of confidence by investors on ratings. These large failures in the ratings of these structured products, which contributed at the peak to more than 40% of the CRAs revenues, proved, once more, some of the intrinsic issues and conflicts of interest of CRAs.

But, even after having realized these large rating failures, simultaneously and surprisingly, regulators, under Basel III, were giving CRAs more rating power and more over reliance by investors than ever before in history!

As a reaction to these failures, a round table of financial economists, assembled in December 2008, proposed that CRAs should increase the transparency of their models, methodologies and practices, that they should be able to be legally prosecuted in case of negligent errors and that public authorities should not delegate their regulatory responsibility to private companies (Goodhart, 2008)

Other economists did show a great degree of skepticism about these measures until the remuneration incentives issue was not changed. That is, CRAs should come back to be remunerated by debt securities investors and not by debt issuers. This serious issue of allying remuneration incentives to end results was somehow similar to another previous case. This was that of the analysts of investment banks, who recommended investors on which shares should they buy or sell, but they had a conflict of interest by being paid by the same investment banks. This problem was finally solved when investment banks were prohibited to fix their remuneration and when analysts were finally paid according to their verified recommendations success (Krawcheck, 2009)

Finally, other economists have conducted research about the interaction between the existing “issuer pays” model of the CRAs and the regulatory use of ratings, such as the use of credit ratings to determine bank capital requirements. They found that, in the absence of regulation, CRAs publish informative ratings, but rating precision tends to be suboptimal. The direction and magnitude of the deviation from the "social optimum" is directly linked to the average quality of the issuers, the complexity of the assets to be issued and the issuers’ outside options, as potentially represented by other rating agencies and other sources of financing. They show that introducing rating contingent regulation that favours highly rated securities may mitigate (or amplify) this suboptimal behaviour, but if sufficiently large, always leads to regulatory arbitrage, rating inflation and complete breakdown of the delegated information acquisition (Opp, Opp and Harris, 2011).

3. CRAS NEW REGULATION AFTER THE FINANCIAL CRISIS

In the US, there was a pre-crisis Credit Rating Agency reform in 2006, in 2010 the Dodd-Frank Act was passed and signed into law, followed by further "Studies".

In the EU, self-regulation was done before the crisis via an IOSCO (International Organizations of Securities Commissions) Code of Conduct. In December 2010 the Regulation (EC) 1060/2009 of the European Parliament and of the Council of 16 September 2009 (referred to as CRA1) entered into force. On 11 May 2011, an amendment to the previous Regulation on CRAs was adopted, adapting it to the creation of ESMA - European Securities and Markets Authority (Regulation (EU) 513/2011, referred to as CRA2).[1]

Finally, on 15 November 2011, the European Commission has proposed a Directive and Regulation to the European Parliament and the Council (referred to as CRA3) with the following four main goals: i) ensuring that financial institutions do not blindly rely only on credit ratings for their investments; ii) more transparent and more frequent sovereign debt ratings; iii) more diversity and stricter independence of credit rating agencies to eliminate conflicts of interest and iv) making CRAs more accountable for the ratings they provide.

1 - New oversight institutions have been introduced: In the US, an "Office of Credit Ratings" has been created within the SEC. In the EU, the 2009 regulation included a registration process and a college of supervisors under the CESR (Committee of European Securities Regulators) guidance. In the Regulation (EU) 513/2011, the supervision was given to a centralized authority: ESMA (European Securities and Markets Authority).

ESMA is an independent EU authority, which will contribute to the stability of the European financial system by ensuring integrity, transparency, efficiency and orderly functioning of securities as well as enhancing investors protection. ESMA fosters supervisory convergence among securities regulators and across financial sectors by working closely with the other European supervisory authorities competent in the field of banking (EBA) and insurance and occupational pensions (EIOPA).

2 - New sanctions have been introduced: In the US the Dodd-Frank Act allows the SEC to bar NRSROs, and to suspend and revoke the NRSRO registration for a particular class of securities. In the EU, ESMA can withdraw registration of any CRA if it no longer meets the conditions or in case of serious or repeated infringement of the regulation.

3 - Regulation of symbols: In the US, Dodd-Frank Act Section 938 allows different symbols for different types of securities and to apply any symbol in a manner that is consistent for all types of securities for which the symbol is used. In the EU, Art 10 of Regulation (EC) No 1060/2009 obliges CRAs to use different rating categories for structured finance instruments which need to use an additional symbol, which distinguish them for rating categories used for any other entities, financial instruments or financial obligations.

4 - Disclosure requirements: In the US, according to Section 932 of the Dodd-Frank Act, CRAs should publish annual reports to the SEC and to the public, including internal controls, compliance, employment transitions, ratings performance transparency, methodologies etc. In the EU, Recital 25 of Regulation (EC) 1060/2009, requires disclosure of methodologies, models and key ratings assumptions, but not of sensitive business

[1] See also: http://ec.europa.eu/internal_market/securities/agencies/index_en.htm

information. Article 12 requires annual transparency reports and Article 11 requires information on historical performance collected in a central repository.

5 - Conflict of interest: In the US, Section 932 of the Dodd-Frank Act, within the governance rules, includes a look-back requirement: CRAs shall i) conduct a review to determine whether any conflict of interest of the employee influenced the credit rating and ii) take action to review the rating, if appropriate. In the EU, Recital 26 of Regulation (EC) No 1060/2009 requires: internal policies to prevent, identify, eliminate or manage and disclosed conflict of interest. Recital 22 and Article 6 prohibite ancillary services if this activity creates conflict of interest with the issuing of credit ratings.

6 - Alternatives to the "issuer-pays" business model: In the US, Senator Franken introduced an amendment by which a central board would have assigned CRAs to provide credit ratings, but the House of Representatives did not accept it in the reform bill. According to the Dodd-Frank Act, two studies have to be conducted on this topic: i) Government Accountability Office study on alternative business models (Section 939D) and ii) SEC study on rulemaking on assigned credit ratings (Section 935F). In the EU, the public consultation on CRAs is discussing on alternative business models: i) Investor-pays model, ii) Payment-upon results model, iii) Government as hiring agent model, iv) Public utility model.

7 - Reducing over-reliance on CRAs: Over-reliance can be of regulatory or behavioral nature.

i) Regulatory reliance: rating-based regulations such as bank capital requirements in Basel II and Basel III, as investment restrictions on certain categories of investors, as well as collateral policies of central banks.

ii) Behavioural reliance: Rating triggers in contracts (rating-based termination provisions and internal investment guidelines) as well as rating-dependent "collateral triggers" in contracting.

In the US the Dodd-Frank Act includes in Section 939 (a-f) a removal of statutory reference to credit ratings and, according to Section 939A, every federal Agency has 1 year to remove regulatory references to credit ratings. The private sector should follow the step to avoid behavioural reliance.

In the EU: in the public consultation on CRAs there was a discussion about over-reliance on credit ratings, on the importance of market participants' own due diligence and internal risk management, as well as considering alternatives to credit ratings such as internal models and market data. Finally, in July 2011 the Commission proposed a new Directive in the context of the so-called CRD IV reducing the number of references to external ratings and requiring financial institutions to do their own due diligence.

8 - Reducing the systemic importance of credit ratings: the FSB principles for reducing reliance on credit ratings (October 2010) includes:

- Financial stability-threatening herding and cliff effects showing that rating downgrades can amplify pro-cyclicality and cause systemic disruption;
- Importance of market participants own due diligence;
- Ending the mechanistic reliance on credit ratings following several principles:

i. for regulators: replacing regulatory references to credit ratings by suitable standards of creditworthiness;

ii. for market participants: encouraging market participants to improve their risk managements and avoiding the use of rating triggers;

iii. for central banks: promoting independent evaluations.

9 - Liability: In the US, the Dodd-Frank has ended the free speech privilege of CRAs and has introduced a liability regime through two dispositions of securities laws. Section 933, State of mind and Section 939G, Expert Liability. In the EU, within the Public Consultation on CRAs, is addressing Civil Liability.

10 - Enhancing competition in the rating industry: In the US, the CRA Reform Act of 2006 introduced competition as a leading objective, but it brought several counterproductive effects, namely “rating shopping” and “race to the bottom”. This because it is not possible to enhance competition so long as CRAs perform a regulatory function more than a private function; therefore it is better to restore market forces prior to increasing the number of CRAs. In the EU, within the Public Consultation, there is the political idea of promoting the establishment of a European CRA, the proposal of introducing new players and of lowering barriers to entry.

In sum, there are three clear trends in regulation on both sides of the Atlantic: first, more regulation and more oversight of CRAs; second, less use of credit ratings and third, find alternatives to credit rating models and eventually to the credit ratings themselves.

The Commission's new proposal on credit rating agencies for a Directive and Regulation (CRA3)

The very recent Directive and Regulation on credit rating agencies proposed by the European Commission on 15 November 2011 introduces further advances in the regulation:

1 - It reduces the number of references to external ratings not only for financial institutions (and requires them to do their own due diligence), but it introduces the same rules to fund managers to be applied to insurance companies next year. It also introduces a general obligation for all investors to do their own assessment. In addition, more and better information underlying the ratings would need to be disclosed by CRAs and by the rated entities themselves, so that professional investors will be better informed in order to make their own judgment. CRAs should communicate their ratings to the ESMA which would make sure that all available ratings on debt market instruments are published under the European Rating Index (EURIX) making the ratings freely available to investors. Moreover, CRAs will have to consult issuers and investors on any intended changes to their rating methodologies. Such changes should be communicated to ESMA.

2 - Member States would be rated more frequently, every six months rather than 12 months, and investors and Member States would be informed of the underlying facts and assumptions on each rating. Sovereign ratings should only be published after the close of business and at least one hour before the opening of trading venues in the EU.

3 - Issuers would have to rotate every three years between the agencies that rate them. In addition, two ratings from two different rating agencies would be required for complex structured finance instruments and a big shareholder of a credit rating agency should not simultaneously be a big shareholder of another rating agency.

4 - A CRA should be liable in case it infringes, intentionally or with gross negligence, the CRA Regulation, thereby causing damage to an investor having relied on the rating that followed such infringement. Such investors should bring their civil liability claims before national courts. The burden of proof would rest on the CRA.

In sum, these proposals seem to be going in the right direction in order to address two CRAs flaws: i) the near total domination by the big three CRAs and ii) the potential conflict of interest between CRAs and the issuers that pay them. At the same time, they try to reduce the addiction and reliance of investors and regulators to CRAs ratings and to increase and encourage the use of internal ratings. Finally they increase CRAs transparency about their methodologies to ESMA.

4. CRAS ISSUES DURING THE EURO AREA SOVEREIGN DEBT CRISIS

Leading CRAs have also been accused of exacerbating the Greek debt crisis by downgrading Greek bonds just as European officials were about to unveil a support plan, as well as of downgrading Portuguese bonds provoking cliff cascading effects.

It is true that there has been an interaction between ratings, short positions in the market and increasing use of the CDS market for default protection. There has also been a clear self-fulfilling interaction between rating downgrading and investors herd behaviour. But this tendency to herd behaviour is mainly a consequence of the huge uncertainty created among investors by European leaders every time they meet. The management of this crisis will become a major lesson of business schools and schools of government at universities as how not to manage a crisis.

Investors, when facing increasing uncertainty, tend to achieve a situation of “bounded rationality” and this more limited rationality makes them to lose confidence and to herd. The problem is that when investors herd, they reach quickly “multiple equilibria” which tend to be extreme. Since the start of the euro area, investors have shown extreme confidence on the monetary union and spreads of most Member States over the bunds benchmark were ridiculously low.

For instance, Spain’s sovereign debt maintained for a long time a spread of 3 basis points versus that of Germany, which was clearly an investor’s mistake of overconfidence on Spain. When the crisis started with Greece in October 2009, investors lost confidence on how the debt crisis was being managed, not only for not letting the IMF resolve the Greek crisis and later reschedule its debt, but for not taking a rational action to avoid contagion.

At the time of writing this briefing paper, in the middle of the growing euro area sovereign debt crisis, France, which is AAA, has a CDS that is the double of that of Chile, which is A+, and higher than those of Mexico and Brazil, which are BBB. Spain, which is AA-, has a CDS which is almost three times higher than that of Chile and two times higher than of those of Mexico and Brazil.

Apparently, this does not make any sense. Either investors who ask for protection in the CDS market do not pay any attention to ratings, or they are useless for them. These discrepancies may be due to different causes. First, to the fact that ratings are long term and CDS spreads are at very short term. Second, CDS spreads are a real market price which changes continuously while ratings are an opinion that changes once or twice a year. Third, ratings only assess the probability of default and CDS also take into account liquidity and depth in the market.

5. THE ECB VIEWS ON CRAS REGULATION

Price stability and financial stability are the two main objectives of the ECB. Therefore the ECB must be very worried about the important effects that the perceived existence of shortcomings in the rating activity performed by CRAs may have on market confidence and their possible adverse effects on financial stability. Even more, when medium term price expectations are below target and, by contrast, increasing sovereign debt problems, herd behaviour and contagion, are affecting very seriously the financial stability of the European banks and other financial institutions, which, in turn, are affecting the monetary transmission mechanism of the ECB's monetary policy, which is essential to meet its price stability objectives.

The ECB presented its views on the regulation of rating agencies on several occasions:

- ECB opinion CON/2009/38 of 21 April 2009[2] on the 2008 Commission proposal for a regulation on credit rating agencies
- ECB opinion CON/2010/82 of 19 November 2010[3] on a proposal for a regulation amending Regulation (EC) No 1060/2009 on credit rating agencies
- In due time, it will most probably provide its views on the recent proposed Directive and Regulation of the EU Commission of 15 November 2011.

In February 2011[4] the Eurosystem responded to the 5 November 2010 Commission consultation paper on credit rating agencies.

Its views are the following:

1 - The Eurosystem supports the Commission's efforts to reduce the reliance of financial markets and the official sector on CRAs ratings and to diminish the impact of "cliff effects" on financial institutions and markets. The ECB response says that the crisis has shown that the over-reliance on ratings, as they are embedded in many regulations and private contracts through rating downgrades (and their spillover effects) can destabilize financial markets. In that sense, the Eurosystem agrees with the Commission's approach consisting of two main pillars: first, requiring financial firms to undertake their own due diligence and internal credit risk assessment and second, reducing the reliance of regulation and supervisory practices on external ratings.

The Eurosystem presents a comprehensive stock-taking exercise of situations where CRAs ratings area embedded in regulations and private contracts, including the use of ratings in the collateralization requirements of OTC derivatives transactions. The crisis has shown that for the survival of firms and to preserve the broader financial stability, financial firms have to make their own credit assessment and due diligence of every transaction they contemplate entering should apply, following the principles of the FSB for reducing reliance on CRA ratings published in October 2010, which states: "Banks, market participants and institutional investors should be expected to make their own assessments and not rely solely or mechanistically on CRA ratings". This, in turn should ensure that financial firms should not invest or trade any product that they do not adequately understand or of which they cannot fully assess the risks.

[2] http://www.ecb.europa.eu/ecb/legal/pdf/c_11520090520en00010014.pdf
[3] http://www.ecb.europa.eu/ecb/legal/pdf/c_33720101214en00010009.pdf
[4] http://www.ecb.int/pub/pdf/other/ecpublicconsultationcreditratingagencieseurosystemreplyen.pdf

The Eurosystem recognizes that, as shown during the crisis, inadequate expertise and excessive reliance on third party assessments are causes of mispricing, panic, sharp sell-offs and contagion.

2 - The Eurosystem warns that vigilance is required regarding measures that would replace one credit risk measure (external rating) by a single alternative measure (single market measure). Hardwiring and automatic reliance on a single credit measure or single third party within regulatory/supervisory and market practices assessment should be avoided. As shown during the crisis these practices lead to forced selling, cliff-effects, severe downward spirals and contagion.

3 - The Eurosystem is cautious against any automatic reliance of regulation on market based variables. Market-based information may be excessively volatile and significantly misleading during times of market dislocation. In these situations, market information can be pro-cyclical resulting in mispricing over longer time periods.

4 - As regards sovereign risk ratings, the Eurosystem believes that internal capabilities to assess sovereign risk should be developed in the general investment framework and credit risk assessment of a financial firm, which should also include the distribution of exposures across several countries.

5 - Internal risk assessments may not be as broad as the ratings analysis from the CRAs and one should keep in mind that some investors and institutions may not have the economies of scale to do their own credit assessments.

6 - The Eurosystem suggests making a distinction between financial institutions' internal assessment and due diligence on the one hand and methods to calculate the required capital requirements on the other hand. Standardized approaches can be used to calculate capital requirements by smaller/less sophisticated firms, while still requiring that these firms develop adequate risk assessments and due diligence capabilities commensurate with their activities.

7 - The Eurosystem supports initiatives to enhance transparency and disclosure of the methodology and rating process in relation to sovereign debt. In addition, the harmonization of key definitions, such as sovereign default, would be welcomed as it would add clarity on the meaning of ratings by different CRAs.

8 - The Eurosystem agrees that sovereign ratings issued in a timely manner and accurately reflecting all of the available information would in turn contribute to reducing volatility of ratings themselves. However, some substantial issues related to the CRAs methodology for sovereign ratings would need further clarification. It is not clear how major facilities established to address the recent crisis, EFSM and EFSF, are evaluated by the rating of the countries concerned. Moreover, sovereign ratings should be reviewed more frequently and regularly at times of crisis. If, for example, CRAs issue regular reports (e.g. weekly) on their monitoring of sovereign under stress, the information shock of a downgrade could be better priced by the markets and multi-notch downgrades would not be necessary.

9 - CRAs should inform country's authorities ahead of the publication of a sovereign rating both for solicited and unsolicited ratings or reviews. Additionally, CRAs should explicitly indicate if a sovereign or supranational rating is unsolicited and the communication of the rating issuance should indicate in detail how the rating methodology departed from the one used for solicited ratings. Often, sovereign ratings do in fact influence markets, although more via credit warnings (outlooks, reviews, and watches) than actual rating changes.

10 - The Eurosystem fully supports measures aimed at increasing the disclosure, transparency and clarity of methodologies, models and assumptions parameters surrounding the approaches adopted by each CRA. Quantitative measures are only one part of the input into sovereign rating decisions. CRAs fail to publicly disclose details on the precise functions and econometric models employed. Given the relatively small number of sovereign defaults, the methodology used by CRAs may not offer a reliable and consistent measure of the sovereign specific credit-worthiness. There is no harmonized definition of sovereign default among CRAs which is reflected also in the calculation of corresponding probabilities of default, so that a better standardization of definitions would help investors to understand ratings themselves and take actions, especially in times of crisis.

11 - The Eurosystem recognizes the issues related to the oligopolistic structure of global credit rating market dominated by a few CRAs and supports the importance of addressing the issue. There are different ways of addressing this problem. One is enhancing competition by facilitating market entry, by increasing transparency of credit ratings as regards data used, methodology and assumptions made by their models (USA). In this context, requiring firms to use at least two external ratings issued by different CRAs and to consider the exposure as unrated, unless at least two external ratings exist, would be easier to implement with a larger offer of external ratings than today. The Eurosystem would support provisions requiring hired CRAs to make accessible the data they received to non hired CRAs, when rating structured finance products and other instruments like corporate bonds.

12 - The ECB should not issue public ratings to be used for regulatory purposes. Notwithstanding, the Eurosystem fully supports the efforts to reduce the reliance of financial markets and the official sector on CRAs ratings and to diminish the impact of “cliff effects” of the regulatory use on financial institutions and markets. In this context the ECB itself started a process to enhance and develop further its internal capabilities for independently assessing the creditworthiness of issuers and issues eligible for credit operations and for critically reviewing external assessments. Every year, the ECB reviews the functioning of the Eurosystem Credit Assessment Framework (ECAF) and allows the recognition, internally to the Eurosystem, of the four in-house credit rating assessments from four EU National Central Banks (France, Germany, Spain and Austria) (please check this lqst sentence).

13 - The Eurosystem believes that the idea of a European Network of small and medium-sized CRAs will help build up expert knowledge and improve methodologies, capable human resources, and data exchanges, development of common IT systems, internal controls and extra capacity that may improve the quality of ratings. Such a network could provide some support in the early stages of a CRA business being set up, each of the CRAS being specialized in different areas. The new CRA regulation also needs to avoid potential exit of some small and medium size CRAs.

14 - A high standard of civil liability for CRAs has been introduced in the US law and a similar standard should be further studied for the EU, making CRAs liable for the performance of ratings when they have failed to conduct reasonable investigation into the facts used by its methodology or verify them if obtained from other parties.

15 - The Eurosystem agrees that the current “issuer-pays” financing model of ratings can be a source of conflict of interest and thus may have a distorting influence on ratings. However, not just the type of payment model can lead to conflict of interest: the lack of transparency regarding payment models and modalities can also lead to less than ideal outcomes. The “subscriber-investor pays model” could be the alternative, but some US evidence shows that newly founded rating agencies are more likely to use the “subscriber-

pays model" than the "issuer-pays model", whereas the bigger CRAs use the "issuer-pays model". However, it is unclear if this is due to timing or perhaps related to the smaller size and higher specialization of the smaller firms. Other models can also involve conflict of interest and bring distortions to the markets, albeit of a different kind.

6. COSTS AND BENEFITS OF A EUROPEAN RATING FOUNDATION

It is understandable to blame CRAs for having rated CDOs making type 1 errors, (a hypothesis such as an structured product is risky is rejected when it should have been accepted) and type 2 errors (a risky structured financial product is accepted when it should have been rejected) and having repeated the same two types of errors when rating European sovereign debt, when compared to similar ratings of the US and the UK sovereign debt (De Grauwe, 2009). It is correct to say that CRAs should have been liable for their ratings on structured mortgage financial products that unchained the financial crisis, however they cannot be blamed for having created the European sovereign debt crisis, but for having exacerbated it with badly timed downgrades, which have produced "cliff effects" and contagion.

The European sovereign debt crisis was announced since the beginning of the 1990s by many economists including myself (de la Dehesa and Krugman, 1992) because the EMU had from the start several design failures and later by basic crisis management failures. It has been made much worse by an incredibly slow and bad management by our European leaders that still carries on at the time of writing this briefing paper after two years, since the breakup of the Greek crisis.

Therefore, the crisis is basically the result of a combination of design and management failures. At the beginning of the euro area, investors trusted fully the EMU, but later realized that the euro area was not an optimal currency area, did not have a lender of last resort in the ECB and did not have a common fiscal policy or, at least, a very large community fund to face asymmetric shocks in Member States. After these discoveries, investors found out that European political leaders were not prepared to fix these design failures.

The non-legislative resolution of the European Parliament, in June 2011, included asking the European Commission to study the potential creation of a new totally independent European Credit Rating Foundation (ECRaF). In principle, given the oligopolistic structure of the supply market for ratings, any new entrant should be welcomed. Nevertheless, it would be a novelty in the market of CRAs, given that, until now, CRAs have been created by the private sector and not promoted by a public body and even more so by a European public institution.

This new ECRaF should not be publicly sponsored even if the Commission would only put seed capital and development capital until the ECRaF would raise enough private capital, because it would not be considered independent and trusted by investors, even more when it would specialize on sovereign ratings. I cannot imagine the European Commission acting as a venture capitalist of the Foundation.

Investors would not take seriously its sovereign ratings because they would find them biased by political interference if the Commission would promote it. The ECRaF should be promoted by groups or associations of independent European investors to have a fourth view on ratings, besides those of the top three oligopolistic CRAs. Being European would be better than being from a defined nationality, given that today sovereign debt securities are national.

Nevertheless, when most of the European issuance would become Eurobonds, if the ECRaF would be public the general suspicion about its lack of independence would be so large that it would fail to attract any investor attention. Therefore, it should be left to private investors, if they see an increasing development of the market for ratings, as it seems to be the trend today, to create new CRAs entrants to compete with the present top three CRAs. They would be much more credible than a publicly sponsored CRA.

Could the ECB be an independent provider of European sovereign credit ratings?

The ECB is in charge of the euro area monetary policy which should be able to achieve price and financial stability and that is already a difficult mandate and a huge task. Even if in the Lisbon Treaty its independence to take decisions is absolute, it should never be engaged in rating its own shareholders which are all the euro area Member States plus the rest of the EU Member States. It would not only be an oxymoron but also a dangerous decision with no support in the Treaties, which would not be approved by its Council because the ECB would lose independence and credibility.

7. CONCLUSIONS

As I mentioned at the beginning, ratings are a public global good, so that they should be improved, enhanced and globalized. Therefore, the best solution for the intrinsic problems of CRAs is a correct regulation and supervision, but both should be based on both harmonized and global standards. The US and Europe should take the lead and harmonize their standards, even if they not became identical. A level playing field would help the development of a larger market and also create incentives for more entrants to compete in the present oligopolistic market.

IOSCO could be the forum where to try to harmonize these standards but also a new global authority could be created, to which individual jurisdictions would delegate their supervision of CRAs (Véron, 2011)

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