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European Union Committee

21st Report of Session 2010–12

Sovereign Credit Ratings: Shooting the Messenger?

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The current staff of the Sub-Committee are Antony Willott (Clerk), Laura Bonacorsi-Macleod (Policy Analyst) and Sarah Yusuf (Committee Assistant).

Contacts for the European Union Committee

Contact details for individual Sub-Committees are given on the website.

General correspondence should be addressed to the Clerk of the European Union Committee, Committee Office, House of Lords, London, SW1A 0PW

General enquiries 020 7219 5791. The Committee's email address is euclords@parliament.uk

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References in footnotes to the Report are as follows:

Q refers to a question in oral evidence;

CED 1 refers to written evidence as listed in Appendix 2.

SUMMARY

The banking crisis in 2008 triggered a crisis of confidence in the financial health of some Member States of the euro area. Concerns over the level of Greece's public debt in late 2009 soon widened to include other euro area countries including Ireland and Portugal. By mid 2011, all three countries had accepted financial assistance from other EU Member States and the International Monetary Fund.

Governments and politicians across Europe have been working to prop up confidence in these economies to prevent market concerns spreading to other euro area economies. Attention has been drawn to the role and behaviour of credit rating agencies and, in particular, the 'big three' agencies: Moody's, Standard and Poor's and Fitch.

The rating agencies were criticised after the banking collapse in 2008 for mis-rating certain financial products, contributing to the severity of the collapse. With their reputations yet to recover, they have now been accused of precipitating and exacerbating the euro area crisis by downgrading the sovereign ratings of Greece, Ireland and Portugal too far and too fast. Politicians across the EU have called for increased regulation and suggested that the oligopoly of the three major rating agencies should be challenged by the promotion or creation of a European credit rating agency. In November 2010 the European Commission launched a consultation on credit rating agencies considering these issues.

The valid charge against the rating agencies, however, is not that they precipitated or exacerbated the euro area crisis, but that they conspicuously failed to challenge the assumptions upon which their assessment of the sustainability of sovereign debt was based in the years running up to the crisis. They thus failed to identify risks in some Member States which began building long before the crisis hit.

The criticism that credit rating agencies precipitated the euro area crisis is largely unjustified; their downgrades merely reflect the seriousness of the problems that some Member States are currently facing. Indeed, in most cases they have followed, rather than led, market sentiment. In addition, their work has been complicated by having to operate against a background of shifting policy initiatives from EU Member States.

Rating agency downgrades can, in certain circumstances, exercise a disproportionate influence on markets, exacerbating already fragile situations. It is not clear, however, that this was the case in the euro area crisis. Given the fast moving nature of recent events and the volatility of financial markets in the aftermath of the 2008 banking collapse we do not believe it is possible to determine the extent to which rating agencies may, or may not, have exacerbated the crisis.

The credit rating agencies received deserved criticism for their role in the banking collapse in 2008. Their role in the on-going euro area crisis is substantially different and justified anger over their previous failures should not be allowed to colour objective assessments of their current decisions relating to EU sovereign debt. For example, the suggestion by Commissioner Barnier, Head of the European Commission Internal Market and Services Directorate-General, that sovereign debt ratings should be suspended for countries in international financial assistance programmes is wholly impractical and smacks of censorship.

The global credit rating industry is, at present, an oligopoly. We believe there is a compelling argument for a thorough competition inquiry into the structure and regulation of the credit rating industry to consider whether greater competition is desirable and, if so, how it might best be increased. We do not, however, support suggestions for any form of publicly-funded European credit rating agency. It is clear that any such agency would lack credibility with the markets given the context in which it was proposed.

A new regulatory framework for rating agencies has only recently been put in place. While not necessarily opposing further regulatory initiatives or measures to increase transparency, we recommend that the new framework be given time to bed down before further changes are made.

We hope that recent events will help ensure that investors see sovereign ratings for what they ultimately are: subjective predictions that rely heavily upon the personal judgement of rating agency staff. Investors should not follow ratings blindly, but view them as opinions that need to be balanced and confirmed by other market indicators. In the end, responsibility for investment decisions ultimately lies with investors and they should bear in the mind the principle of *caveat emptor* when deciding how much reliance to place on the judgement of rating agencies.

Credit Rating Agencies

CHAPTER 1: INTRODUCTION

An overview of the credit rating industry

1. Credit rating agencies (CRAs) provide an independent analysis of risks in the financial markets by assessing the creditworthiness of issuers or of financial obligations. By offering a comparative analysis of the risks posed by different issuers they allow investors to compare ‘apples and pears’ when determining where to invest their money. CRAs rate a wide range of bodies, including sovereigns (governments),¹ local authorities, financial institutions and corporate organisations, as well as rating specific financial products. This report focuses on the rating of sovereign debt.
2. The global credit rating industry is dominated by a small number of private companies: Moody’s Investors Service (Moody’s), Standard & Poor’s Ratings Services (S&P) and Fitch Ratings (Fitch). In addition to these ‘big three’ companies, there are a number of smaller rating agencies across the world, often focusing on niche or regional markets. Recently Dagong, China’s dominant credit rating agency, announced that it would be issuing sovereign ratings in an attempt to emerge onto the global market.
3. Rating agencies operate on an ‘issuer-pays’ model, in which issuers pay CRAs to rate their debt or financial products. CRAs also provide a number of ‘unsolicited’ ratings. These are ratings which “are not initiated at the request of the issuer or rated entity”.² In the context of sovereign ratings, CRAs typically provide unsolicited ratings of the countries with the largest economies such as the United States, Germany and the UK.³
4. Rating agencies categorise into grades the risk of default (the likelihood that a borrower will be unable fully to repay the lender the capital borrowed plus any interest owed). Most agencies make a distinction between investment grade (low-risk) and speculative grade (higher-risk) ratings. The three main rating agencies use similar rating scales. The top category is triple-A which denotes a very safe investment. For example, the UK, German and the United States governments all currently have triple-A ratings with the big three credit rating agencies.

¹ Throughout this report, the term ‘sovereign’ is synonymous with national government.

² CED 17

³ For example, S&P informed us that worldwide they maintain credit ratings of 126 sovereigns, of which 15 are unsolicited.

TABLE 1

Rating scales of the major credit rating agencies

Standard and Poor's	Moody's ⁴	Fitch ⁵
Investment Grade		
AAA	Aaa	AAA
AA	Aa	AA
A	A	A
BBB	Baa	BBB
Speculative Grade		
BB	Ba	BB
B	B	B
CCC	Caa	CCC
CC	Ca (Likely in or near default)	CC
R (Under regulatory supervision)	C (Typically in default)	C (Default is imminent or inevitable)
SD (Selective default)		RD (Restricted default)
D (General default)		D (In bankruptcy, administration, etc)

5. Credit ratings are widely used in financial markets. This is partly because of the simplicity and comparability of the agencies' risk grading system. In addition, however, ratings are 'hard-wired'⁶ into financial regulations, making them a critical tool that both regulators and financial institutions rely upon.

The financial crisis

6. The period preceding the onset of the financial crisis in 2007 saw the rise of complex financial products, such as mortgage-backed securities, which were rated highly by the rating agencies. When the crisis hit, however, it appeared that the rating agencies had vastly underestimated the risk these products posed. The Open Europe think tank described the result: "there was a series of large downgrades [by the CRAs] on many of these assets, further provoking the crisis and causing chaos in financial markets. Significantly, this caused a massive shortage of liquidity at a time when it could least be afforded".⁷ Dr John Ryan, a Fellow at the Center for Economic Policy

⁴ Moody's appends numerical modifiers 1,2 and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of the category. Conversely, the modifier 3 indicates a ranking at the lower end of the spectrum.

⁵ Fitch may add the modifiers '+' or '-' to denote relative status within rating categories.

⁶ Ratings are built into financial regulations, making them an integral part of the financial system. See paragraphs 54-55 for more detail.

⁷ CED 14

Analysis, University of Venice and the German Institute for International and Security Affairs, described how the CRAs collectively downgraded \$1.9 trillion in mortgage-backed securities between late 2007 and mid-2008. Some securities that had carried a triple-A rating one day were downgraded to CCC the next.⁸ Ms Barbara Ridpath, Chief Executive of the independent research institute the International Centre for Financial Regulation (ICFR), told us these events were, in her experience, “the biggest mistake they [CRAs] have ever made”.⁹

7. Following these events the credit rating agencies were accused of mis-rating financial products, particularly mortgage-backed securities, contributing to the severity of the crisis. Concerns were raised about the conflicts of interests inherent in the ‘issuer-pays model’, whereby the CRAs are paid by the organisations whose financial products they rate. Dr Marco Annunziata, Chief Economist at Unicredit Group, told us that these concerns have “been at the centre of the debate on structured products”.¹⁰ We consider the issues surrounding conflicts of interests in more detail in Chapter 5.

Regulatory reform

8. In the aftermath of the financial crisis governments acted to increase regulation of the credit rating industry and reduce their importance in the markets. The EU put in place a regulatory regime¹¹ that established mandatory registration for all CRAs operating in the EU. It also included measures to improve the transparency of CRAs’ activities, reduce conflicts of interest and increase regulatory oversight of CRAs.¹² Recently, this regulatory regime has been amended to put CRAs under the direct supervision of the newly created European Securities Markets Authority (ESMA).¹³
9. Similar actions were taken forward in the wider international community. The Financial Stability Board, founded by the G20 in 2009 to promote financial stability, produced a report calling on governments to act to reduce the markets’ reliance on ratings in standards, laws and regulations.¹⁴ In the US, the Dodd-Frank Act of 2010 focused heavily on the reform of rating agencies. It provides for increased supervision of the credit rating industry and a reduction in the regulatory reliance on ratings, and addresses the issue of conflicts of interest. We consider the current and future regulation of CRAs in more detail in Chapter 5.

The euro area sovereign debt crisis

10. The worldwide financial crisis triggered a crisis of confidence in the financial health of some Member States of the euro area. Following the release of new information by the Greek authorities in autumn 2009, concerns over the level of Greece’s budget deficit and public debt meant that the Greek

⁸ CED 10

⁹ Q 98

¹⁰ CED 12

¹¹ Regulation (EC) No 1060/2009 on credit rating agencies

¹² The Committee considered the impact of these regulations on the credit rating agencies in a previous report: Lords European Union Committee 14th Report (2008–09): *The future of EU financial regulation and supervision*, HL 106.

¹³ Regulation (EU) No 513/2011 amending Regulation (EC) No 1060/2009 on credit rating agencies

¹⁴ Financial Stability Board, *Principles for Reducing Reliance on CRA Ratings*, October 2010

government's ability to finance its borrowing deteriorated. Concerns soon widened to include other euro area countries including Ireland and Portugal. By late 2010 Greece and Ireland had accepted financial assistance from emergency liquidity funds established by the EU and euro area Member States. Portugal followed in early 2011.

11. With their reputations still recovering from their actions during the recent financial crisis, the CRAs have been the subject of controversy during the sovereign debt crisis. They have been accused both of failing to predict the crisis, and then precipitating it by downgrading the ratings of euro area sovereigns too far and too fast. Politicians across Europe have called for restrictions on the role of CRAs in rating sovereign debt and increased regulation. Some have suggested that the EU should support or create a European credit rating agency to challenge the dominance of the 'big three' agencies. We consider the role the rating agencies played in the euro area crisis in Chapter 3, and the idea of a European rating agency in more detail in Chapter 4.

The inquiry

12. In November 2010 the European Commission launched a public consultation on credit rating agencies (the 'Commission consultation') to discuss the need for further regulation in the credit rating industry, including whether the EU regulatory framework needed to be strengthened "to ensure further transparency and enhance the quality of sovereign debt ratings".¹⁵ The consultation also asks for views on various proposals for a European credit rating foundation.
13. In light of this consultation and the possibility of further legislative proposals from the Commission we launched an inquiry to consider the interaction between the credit rating agencies and sovereign debt, with a particular focus on their role in the euro area crisis. Although in this report we make reference to the rating agencies' activities in the private sector and their actions before and during the financial crisis, our inquiry has focused on issues arising from their role in the sovereign debt sphere.
14. On some issues, such as conflicts of interest, we have found that the problems mainly lie in the private sphere: we have not explored these issues in detail although we have noted where concerns have arisen. In other areas, such as the use of ratings in regulation, we have highlighted issues that affect private and sovereign debt equally. We consider these areas in some detail.
15. This inquiry has been fast-moving, with both credit rating agencies and politicians taking decisions and suggesting new solutions on an almost daily basis. This report is up to date as of Tuesday 12 July. We have not considered any further developments that may have occurred beyond that date.
16. The membership of Sub-Committee A which undertook this inquiry is set out in Appendix 1. We are grateful to those who submitted written and oral evidence, who are listed in Appendix 2. The evidence taken as part of this inquiry was taken in May and June 2011.
17. **We make this report to the House for debate.**

¹⁵ European Commission, *Public consultation on credit rating agencies*, November 2010

CHAPTER 2: SOVEREIGN DEBT AND RATINGS

Sovereign ratings

18. Sovereign ratings are an assessment of a Government's ability and willingness to repay its public debt on time. They provide "an independent and broadly accepted measure and relative ranking of the creditworthiness of Governments".¹⁶ A study by the European Central Bank (ECB), *What hides behind sovereign debt*, summarises the importance of sovereign ratings:

"First, sovereign ratings are a key determinant of the interest rates a country faces in the international financial market and therefore of its borrowing costs. Second, sovereign ratings may have a constraining impact on the ratings assigned to domestic banks or companies. Third, some institutional investors have lower bounds for the risk they can assume in their investments. Consequently, they choose their bond portfolio composition taking into account the credit risk perceived by the rating notations."¹⁷

19. Moody's told us that they also have an impact on investor behaviour outside the sovereign debt market. Since national governments are the largest borrowers in capital markets, accounting for more than 60% of debt issued, sovereign ratings will often have an important role in providing a baseline for investors' risk expectations.¹⁸

Are sovereign ratings necessary?

20. The International Centre for Financial Regulation (ICFR) argued that "most sovereign borrowers have a fundamental need to find investors for their debt beyond their own borders". Sovereign ratings facilitate this by providing investors with a way "of comparing available investments as to their credit quality, particularly outside of their home market, in light of the lack of consistent standards on government accounting across borders". In the absence of sovereign ratings, investment groups would either have to invest significant resources to conduct the work themselves, or limit their investments to those countries whose credit quality could be easily grasped.¹⁹ A different view was given by the Association of British Insurers (ABI), who told us that some of its members held the view that "CRA concept may have passed its sell-by-date" since ratings "add little additional value to the information provided by analysts or the markets themselves".²⁰
21. The Investment Management Association (IMA) stressed the need for sovereign ratings: "efficient price formation can only be achieved if the market and investors have access to as many sources of information as possible, of which private CRAs are one. To prohibit them from publishing opinions or ratings would be counter-productive".²¹ The Government told us

¹⁶ CED 12 (Dr Annunziata)

¹⁷ European Central Bank, Working Paper Series No 711, *What "hides" behind sovereign debt ratings?*, January 2007

¹⁸ CED 6

¹⁹ CED 13

²⁰ CED 4

²¹ CED 2

that CRAs were playing an important role. Investors need sound information to decide which assets to invest in, but information disclosed by the owner of the asset would be regarded as biased. CRAs address this information gap by providing a third party assessment of creditworthiness “that investors believe is credible”.²²

22. **Sovereign ratings can play a useful role that contributes to the smooth and efficient working of the worldwide sovereign debt market. We note that sovereign ratings play a significant role in determining the cost to a government of borrowing money.**

Sovereign rating methodologies

23. Credit rating agencies have in place overarching analytical frameworks, or methodologies, that they use to assess the creditworthiness of sovereigns. Before turning to the events of the euro area crisis in Chapter 3, we consider first a number of issues that arose in discussions of the rating agencies’ methodologies.

Assessing the future: the subjective nature of ratings

24. Credit ratings are based on a combination of quantitative and qualitative indicators and, ultimately, the personal judgement of rating agency staff. The quantitative indicators will include factors such as: economic growth; trends in macroeconomic policies; the level and stability of interest rates and exchange rates, and the degree of liquidity of the debt issued; and the average maturity of existing debt.²³ This information is publicly available and is available to all investors.
25. When rating corporate debt, CRAs are often given access to privileged information to ensure that their rating is as accurate as possible. Investors often place great weight on corporate ratings because they assume the ratings agencies have “inside information”.²⁴ Some commentators have suggested that because nearly all information relating to countries’ public finances is publicly available, rating agencies add less value to the market in relation to sovereign debt.²⁵
26. Mr Frederic Drevon, Regional Head for Europe, the Middle East and Africa at Moody’s, suggested that CRAs may in fact indeed receive a certain amount of privileged information when rating sovereigns. He told us that Moody’s develops a country analysis “based on public information and inside stuff that that person may have received via visits with Treasury officials. He may have access to non-public information, which would obviously be kept confidential”.²⁶ Ms Ridpath, while noting that the factual information used in sovereign ratings was “overwhelmingly public”,²⁷ said that CRAs were sometimes able to use private International Monetary Fund (IMF) reports

²² CED 1. Other witnesses also thought ratings played an important role. See CED 5, 12

²³ CED 12

²⁴ Q 112

²⁵ See, for example, Helmut Reisen, VoxEU.org, *Boom, bust and sovereign ratings: Lessons for the Eurozone from emerging-market ratings*, 2010

²⁶ Q 6

²⁷ Q 112

that were not in the public domain.²⁸ She felt, though, that CRAs added value for the markets through listening to government officials discuss how they would address different scenarios to better assess factors like their risk appetite and political will. She stated that “that kind of interviewing can be extraordinarily helpful”.²⁹

27. In addition to measurable economic factors, CRAs have to use a large degree of judgement in determining the final rating grade. Mr Drevon told us “we do not have a perfect crystal ball in trying to analyse the future”; rating agencies inevitably used methodologies that were not “completely and perfectly scientific”.³⁰ Mr Paul Taylor, President of Fitch Ratings, used the example of the euro area crisis to illustrate the point:

“if you think about where we are with something like Greece or Portugal at the moment, do you think the German Government will continue to show support to those countries? It is a political decision. It is not an economic, numbers-driven decision. You cannot look at a set of statistics and say that therefore Greece, Portugal or Spain will fail”.³¹

28. Mr Mark Hoban MP, Financial Secretary to HM Treasury, recognised that methodologies were not “simply a mechanistic process”. He told us “clearly there has to be judgement applied to that. Otherwise we would all be able to become our own instant credit rating agencies by producing an iPhone app”.³² Indeed he argued that “where they add value is their methodology, their analysis and their judgement”.³³
29. Dr Blundell-Wignall, Deputy Director in the Directorate for Financial and Enterprise Affairs and Special Advisor to the Secretary-General on Financial Markets at the Organisation for Economic Cooperation and Development (OECD), was less happy with the subjective nature of the ratings: “that degree of arbitrariness is a concern”.³⁴ He also noted that, when consulted by S&P during a review of its methodologies, the OECD had expressed some concerns. S&P score a large number of indicators, but give each of them equal weighting. This resulted in what he called “a linearity bias”.³⁵ Mr David Beers, Head of Global Sovereign and International Public Finance Ratings at S&P, however, told us bluntly that “ultimately you have to make a judgement, because the essential issue with credit risk is about the future, which is uncertain”.³⁶
30. The rating agencies stressed that the subjective nature of their ratings meant that “ratings are purely an expression of our opinions as to the risk of future payment default, they are neither correct nor incorrect”.³⁷ As with all predictions, “the future can turn out to be very different from what was

²⁸ QQ 89–91

²⁹ Q 112

³⁰ Q 6

³¹ Q 8

³² Q 137

³³ Q 149

³⁴ Q 57

³⁵ Q 56. By averaging the different scores, the individual weight of each indicator becomes less important.

³⁶ Q 8

³⁷ CED 7

forecasted”.³⁸ Dr Ryan summarised the issue: “CRAs are not an absolute predictor of whether a particular debtor will default”.³⁹

31. The Minister drew the following conclusions: “there is a lot that is down to judgement ... [therefore] no one should use ratings in isolation. I think that investors should make their own judgements, and ratings are a part of that judgement process but not the be all and end all of that process”.⁴⁰ Ms Ridpath concurred: “investors ... should not just take what they say and buy or sell accordingly, because those are not buy and sell recommendations, but they can use that analysis as a shortcut to making their own judgements”.⁴¹
32. This necessary change in behaviour may already be in progress. The European Association of Credit Rating Agencies (EACRA) noted that “several studies have shown that reliance on ratings by investors has substantially decreased since the financial crisis erupted ... whereas rating actions before the crisis fed directly into CDS or other market measures, this automatic link has substantially weakened, investors assessing themselves the associated risks and using external ratings as an additional information”.⁴² The ECB have suggested that a single basic principle should apply: financial firms should have to do their own credit assessment of every transaction they enter, and they “should not invest or trade in any product which that they do not adequately understand or of which they cannot fully assess the risks”.⁴³
33. **We recognise that sovereign ratings involve a mix of quantitative and qualitative assessments. They are not the result of a mechanistic process, but ultimately subjective views relying heavily on the judgement of the rating agencies. Investors should not rely solely on sovereign ratings as an authoritative indicator of creditworthiness, but view them as opinions that need to be balanced and confirmed by other market indicators.**

Unsteady foundations

34. One of the reasons given for the sudden and sharp cuts to Greece’s credit rating was the Greek government’s sudden revision of some of its statistics concerning the national debt and deficit.⁴⁴ The IMA noted that one of the challenges faced in assessing sovereign debt was that “the quality of some information from governmental authorities might also be questionable”.⁴⁵ The Minister recognised this concern: “it is important to the whole credit rating process ... that the underlying data is robust and has integrity”. He suggested that “there are remedies that we need to have in place, to ensure the quality of the data that credit rating agencies have available to them is higher than it has been in the past ... that is not just for the benefit of credit rating agencies, it is to the benefit of all those who have an interest in that statistical data”.⁴⁶

³⁸ CED 8

³⁹ CED 10

⁴⁰ Q 139

⁴¹ Q 93

⁴² CED 11

⁴³ European Central Bank, *European Commission’s Public Consultation on Credit Rating Agencies—Eurosystem Reply*, February 2011

⁴⁴ CED 8, 12

⁴⁵ CED 2

⁴⁶ Q 147

35. Since the accuracy of the data underlying the rating agencies' methodologies and judgements has a direct impact on the reliability of their ratings, it is in the interests of investors that sovereigns are as open and honest with rating agencies as possible. The Minister told us that it was "helpful for sovereigns to engage with rating agencies and not hold them at arm's length" since "you end up with a more accurate rating".⁴⁷ We agree, and we believe this is particularly important since the regulatory framework put in place by Member States uses ratings as an objective measure of creditworthiness. We were concerned, therefore, to hear that some EU Member States refuse to participate in the rating process of some of the large rating agencies.⁴⁸
36. **In our report, *The future of Economic Governance in the EU*, we concluded that "accurate and comparable statistics are essential if there is to be effective economic coordination between Member States". We recognise a similar need for accurate national statistics to ensure that the rating agencies present an accurate portrayal of a country's creditworthiness. We therefore reiterate our recommendation, set out in that report, that the Commission should bring forward legislative proposals to improve the quality of national statistical data and to strengthen further Eurostat's powers.**⁴⁹
37. **While ratings are relied upon by the regulatory framework⁵⁰ we believe it is only appropriate that sovereigns should cooperate with credit rating agencies to ensure that their ratings are as accurate as possible.**
38. In a speech on Monday 11 July Commissioner Michel Barnier, Head of the European Commission Internal Market and Services Directorate-General, pressed forward with an idea first suggested by Madame Christine Lagarde, Managing Director of the IMF, and stated that he will ask European Finance Ministers to consider suspending sovereign credit ratings for Member States which are in internationally agreed assistance programmes. Commissioner Barnier suggested that "we should ask ourselves, in the same way as Madame Lagarde has, whether it is appropriate to allow sovereign ratings on countries which are subject to an internationally agreed programme".⁵¹
39. **This suggestion is entirely inappropriate. The idea that credit ratings should be suspended for countries receiving international financial assistance is wholly impractical given that all of the 'big three' agencies are headquartered in the US. Furthermore, it smacks of censorship.**

⁴⁷ Q 155

⁴⁸ We were informed that Germany decline to participate in either Fitch or S&P's rating process, while the Netherlands do not cooperate with S&P. See CED 15, 16, 17

⁴⁹ European Union Committee, 12th Report (2010–11): *The future of economic governance in the EU* (HL Paper 124), paragraph 77

⁵⁰ See paragraphs 54–55 for more detail on this issue.

⁵¹ Commissioner Barnier, quoted in the Financial Times, *EU plan to provide shelter from rating downgrade*, 12 July 2011

CHAPTER 3: THE EURO AREA CRISIS

Predicting the crisis

40. Whilst recognising the subjective nature of credit ratings, and that the CRAs were reliant on the accuracy of Member States' statistics, we were concerned that the rating agencies did not seem to recognise emerging problems in the euro area until far too late. In our recent report, *The future of economic governance in the EU*, we described a series of shortcomings in the architecture of the Monetary Union. These were exacerbated by a failure of the markets to understand the construction of the euro area. Markets treated the euro area as a single entity without considering, and acting on, the financial health of individual Member States. Until recently there was, for example, little difference between the cost of Greek and German sovereign debt.⁵²
41. From the inception of the euro until the start of 2009, Ireland was rated triple-A, i.e. on a par with Germany, by all the 'big three' agencies. By early 2011 all three CRAs has downgraded their debt to BAA (Moody's) or BBB (S&P and Fitch), only one step above speculative grade. Portugal went from having an AA rating with all three agencies in 2009, to BAA or BBB in 2011. Greece's sovereign rating changed even more dramatically. Moody's, for example, having made no changes from 2003 until 2009, downgraded Greece by nine notches in the space of 440 days, astonishing some market analysts, one of whom noted "nobody's credit, whether it be a company or sovereign, changes that quickly".⁵³ The rating agencies continue to downgrade these states. As this report was being written, Moody's downgraded Portugal even further to Ba: a speculative, or 'junk' grade. We asked the rating agencies why they did not foresee the problems that caused the euro area crisis.
42. Mr Beers argued that "S&P's position, from even before the creation of the Eurozone, was that we did not view all the sovereigns as AAA. We differentiated these opinions from the outset. The market ignored those opinions for many years".⁵⁴ He added: "At the outset we said that we thought that default was possible by sovereign Governments within the Eurozone".⁵⁵ Nevertheless, as we describe above there were sudden and dramatic rating changes made by the CRAs. Some of our witnesses suggested that the CRAs were simply reacting to "sudden and significant revisions of available data",⁵⁶ such as happened with Greece, or reflecting unexpected events, such as Ireland's decision to offer a blanket guarantee to depositors. Mr Taylor admitted that "we did not anticipate the scale of the banking crisis in Ireland and the impact it would have on the financial position of the Irish government".⁵⁷
43. While acknowledging that it was appropriate to question the rating agencies' foresight, the Minister commented that "it is difficult to see why credit rating

⁵² Lords European Union Committee, *The future of economic governance in the EU*

⁵³ CED 9

⁵⁴ Q 3

⁵⁵ Q 4

⁵⁶ CED 12

⁵⁷ CED 8

agencies should possess a superior knowledge to the rest of us”,⁵⁸ and added “I do not think an absence of judgement by the credit rating agencies marks them out to be in any way particularly different from any other agency or body involved in this process”.⁵⁹

44. **We do not agree with the Minister’s assessment. The failure of the credit rating agencies to challenge the fundamental assumptions on which their assessment of the sustainability of sovereign debt in the euro area was based meant there was inadequate differentiation between the sovereign debt of individual countries. We recognise that the rating agencies were not alone in failing to fully understand the extent of the problems developing in certain Member States, but this does not absolve their failure to assess properly the financial health of certain euro area Member States in the run-up to the sovereign debt crisis.**

Precipitating the crisis?

45. Credit rating agencies have been criticised sharply by European politicians for their decisions to downgrade certain euro area economies over the past year. It has been suggested that they precipitated the crisis by downgrading sovereigns too far and too fast, and are therefore responsible for worsening the position of countries such as Greece and Portugal. In March 2011, for example, the Greek government criticised Moody’s for downgrading its rating, stating that “its timing and the multi-notch nature of the downgrade are incomprehensible”. It added:

“At a time when the global economy is fragile and market sentiment is sensitive, unbalanced and unjustified rating decisions such as Moody’s today can initiate damaging self-fulfilling prophecies and certainly strengthen the arguments for tighter regulation of the rating agencies themselves”.⁶⁰

46. Members of the European Parliament and the Commission have also been publicly critical of the rating agencies. Mr Jurgen Klute MEP stated in an interview that CRAs “are creating false panic based on their views about an otherwise implausible default of the southern EU states and encouraging speculation”.⁶¹ Dr Olli Rehn, European Commissioner for Economic and Monetary Affairs, argued in a debate at the European Parliament that Moody’s decision to downgrade Greece’s rating in mid-June 2010 was “both surprising and highly unfortunate”, and suggested that it raised further questions about the need for further regulation of industry.⁶²
47. Critics have also suggested that the CRAs have released ratings at inappropriate times without considering the potential impact of their decisions, or waiting for key policy decisions to be taken. In April 2010, for example, S&P decided to downgrade Greece’s credit rating to BB+, below investment grade, shortly before a financial assistance package was due to be

⁵⁸ Q 144

⁵⁹ Q 147

⁶⁰ Hellenic Republic Ministry of Finance, *Announcement regarding Moody’s downgrading of the Greek sovereign debt rating*, March 2011

⁶¹ Europarl interview with Jurgen Klute MEP, *Rein in the rating agencies, says Jurgen Klute*, 7 June 2010

⁶² European Commissioner Olli Rehn, Remarks made during a European Parliament Debate, 15 June 2010

agreed with euro area Member States and the IMF. Dr Wolf Klinz MEP explained his reservations about the CRAs' behaviour: "the rating agencies on the one hand smooth their ratings over a long period of time and they hold on to a specific rating far longer than really justified ... and then all of a sudden, and particularly a few days before very decisive meetings, they start downgrading. ... Of course this is worsening the situation".⁶³

48. Our witnesses generally felt this criticism was unjustified. Rather than precipitating the crisis we heard that in fact rating changes tend to lag behind market developments.⁶⁴ Dr Blundell-Wignall, for example, told us that the CRAs "tended to follow rather than lead the process".⁶⁵ Ms Ridpath noted that this was deliberate. The CRAs were "very conscious of their capacity to precipitate a crisis by moving too quickly" and so while they tend to be behind most investors, it "is an intentional slowness which avoids false positives in their work".⁶⁶ Mr Drevon supported Ms Ridpath's view, stating that the CRAs' assessment process "will naturally take longer than the instant reaction of the market when news comes out".⁶⁷ Mr Taylor added that in comparison to market volatility, "ratings are more stable and consistent and they tend to move less frequently and in a less volatile manner. There will always be exceptions to that, but ... that is generally the case".⁶⁸
49. Other observers have suggested that, rather than properly assessing the risk of sovereign default and taking a longer-term view, CRAs are simply reflecting the views of the markets at a time when turbulence is making the financial markets' judgement unreliable. Dr Lorenzo Bini Smaghi, a member of the ECB Executive Board, suggested in a speech that some of the downward revisions of sovereign ratings "were not based on macroeconomic data or new budgets, but on the assessments given by the market for sovereign bonds and the possibility of contagion".⁶⁹ He was echoed by Mr Strauss-Kahn, then Managing Director of the IMF, who noted that rating agencies "are reflecting what they are collecting in the market One should not believe too much what they say, even if they are useful".⁷⁰
50. Dr Annunziata argued, however, that:
- "there is an inevitable element of interplay between CRAs decisions and financial sector dynamics. If market sentiment towards a sovereign issuer deteriorates significantly, so that it becomes a lot more expensive and difficult for the sovereign to finance its debt, the risk that it might eventually default increases. CRAs cannot completely ignore such a development that objectively affects the solvency of the issuing sovereign".⁷¹
51. The Minister suggested that the sovereign rating changes taking place in the euro area reflected the fact that "Europe has experienced fundamental

⁶³ Q 132

⁶⁴ Q 166, CED 11, 12

⁶⁵ Q 45

⁶⁶ Q 105

⁶⁷ Q 2

⁶⁸ Q 1

⁶⁹ Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, *Unione Cristiana Imprenditori Dirigenti in Milan, Lessons of the crisis: Ethics, Markets, Democracy*, 13 May 2010

⁷⁰ BBC News, *Greece crisis: Fears grow that it could spread*, 28 April 2010

⁷¹ CED 12

internal and external imbalances” and that the timing of their ratings simply indicated that the rating agencies “update ratings in response to information as it appears”.⁷² The ABI remarked that “symptoms should not be confused with cause” and argued that there was no point “shooting the messenger”.⁷³ Open Europe, meanwhile, remarked that “the series of downgrades which many countries have faced ... are ultimately due to the poor health of these economies, and not the result of the sinister plot portrayed by some senior political figures. Importantly, there seems to have been little for CRAs to gain from these downgrades”.⁷⁴ The ICFR added that part of the frustration revealed by EU policy makers may be because the rating agencies “make it more difficult to resolve Member State fiscal and debt issues behind closed doors”.⁷⁵

52. **We do not believe that the credit rating agencies precipitated the euro area crisis. Their rating downgrades merely reflect the seriousness of the problems that sovereigns are currently experiencing in the euro area and in most cases they have followed, rather than led, market sentiment. In addition, the rating agencies have had to operate against a background of shifting policy initiatives from EU Member States which has complicated their work. We do not believe, therefore, that calls for further regulation of credit rating agencies can be justified on the basis of their actions during the euro area crisis.**

Exacerbating the crisis?

53. While we judged that the criticism levied at the decisions taken by credit rating agencies was in large part unjustified, there is little doubt that the markets can sometimes react dramatically to rating changes, worsening the situation of borrowers already in difficult circumstances. According to an IMF study, *Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis*, sovereign rating downgrades can have “statistically and economically significant spillover effects” which imply that “rating agencies announcements could spur financial instability”. The spillover effects depend both on the type of rating announcements, on the country experiencing the downgrade and the agency that decides on the rating. In particular though, rating downgrades near speculative grade can have systemic spillover effects.⁷⁶
54. The CRAs’ influence over the markets comes, in part, from their use in regulations and investment mandates. Their use in regulatory regimes has meant ratings are “institutionalised”; that is, they are ‘hard-wired’ into standards and regulations. A recent Bank of England Financial Stability Paper *Whither the credit ratings industry?* described how “perhaps the most pervasive use of CRA ratings in regulation is in determining net or regulatory capital requirements for banks, securities firms and insurance companies”.⁷⁷

⁷² Q 136

⁷³ CED 4

⁷⁴ CED 14

⁷⁵ CED 13

⁷⁶ IMF Working Paper, Arezki R, Candelon B, Sy ANR, *Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis*, March 2011

⁷⁷ Bank of England Financial Stability Paper No. 9, *Whither the credit ratings industry?*, March 2011

These rules are based on the Basel Accords, which set global standards on capital and banking regulation, and currently provide rating agencies with a key role in global regulatory systems. Dr Ryan told us that ratings have become a “regulatory licence that allows money to flow” because they “unlock markets”.⁷⁸

55. In the private sector, Dr Ryan suggested that the influence of ratings has spread even further because “institutional investors came to rely on ratings for contracts that don’t even need regulatory approval”.⁷⁹ Dr Annunziata described this role of ratings in investment mandates and private contracts:

“some large institutional investors like mutual funds, pension funds and insurance companies, have investment mandates that are defined also in terms of ratings. For example, a mutual fund could have one or more specific investment funds which are restricted to bonds whose rating is no lower than a certain threshold (for example only ‘investment grade’ bonds)”.⁸⁰

56. The use of ratings in either regulations or investment mandates and private contracts have a similar effect therefore, which is to leave the market over-reliant on ratings. It can cause ‘cliff-edge’ effects where a rating change forces a number of market participants to sell simultaneously. If, for example, an investor can only hold investment grade bonds, a decision by a CRA to lower the rating of a country’s debt would automatically force them to sell their holdings. The Financial Stability Board has stated that “CRA rating downgrades can amplify procyclicality and cause systemic disruptions” and cause “herding in market behaviour if regulations effectively require or incentivise large numbers of market participants to act in similar fashion”.⁸¹ The Government told us that “the UK Authorities hold the view that the hardwiring and the mechanistic reliance on CRAs materially contributed to instability during the financial crisis”.⁸² Other witnesses noted the significant impact of ‘cliff-edge’ effects and argued that these could magnify the effect of CRA rating changes in certain circumstances. The rating agencies recognised this effect,⁸³ with Moody’s agreeing that they could cause “individual rating actions to have disproportionate effects”.⁸⁴
57. We asked our witnesses whether the actions of the ratings agencies had exacerbated the euro area crisis. The rating agencies argued they had not. Fitch, while admitting that ratings were “high profile”, suggested that the CRAs’ role was “much more limited than suggested” and argued that there was little evidence that ratings had exacerbated the current crisis.⁸⁵ Moody’s commented that “it is possible that market reactions ... would have been far more extreme if based solely on market prices without the moderating force which ratings can provide”.⁸⁶

⁷⁸ CED 10

⁷⁹ CED 10

⁸⁰ CED 12

⁸¹ Financial Stability Board, *Principles for Reducing Reliance on CRA Ratings*

⁸² CED 1

⁸³ CED 6, 8

⁸⁴ CED 6

⁸⁵ CED 8

⁸⁶ CED 6

58. Several other witnesses supported the rating agencies' view. The Minister told us that investors had looked at a range of issues during the euro area crisis, and while these included ratings, "I do not think their actions have been driven solely by ratings".⁸⁷ Dr Blundell-Wignall told us that "it is hard for me to imagine that they exacerbated the process".⁸⁸ Other witnesses expressed similar opinions.⁸⁹
59. Dr Klinz, however, told us that although rating agencies "are not the sole cause of the crisis" he thought "they did play a role".⁹⁰ Open Europe thought that the financial markets had indeed reacted too strongly to rating downgrades although they noted that "it is not the CRAs' fault if markets overreact to their rating decisions. It is the herd nature of financial markets, which is always worse in a crisis—a risk that all countries accept when they take on debt sold to the market. The simple fact is, if countries do not like this they should avoid taking on a lot of debt".⁹¹
60. **We recognise that rating changes can have disproportionate effects on the financial markets in certain circumstances. It is not entirely clear, however, that this has happened in the euro area crisis. Given the fast-moving nature of the euro area crisis and the volatility of the financial markets in the aftermath of the financial crisis, we do not believe that it is possible to determine the extent to which rating agencies may or may not have exacerbated the crisis.**
61. There was general agreement among our witnesses that the markets' reliance on ratings needed to be reduced as much as possible.⁹² The Minister felt that this would "solve much of the instability associated with CRA ratings".⁹³ This view was echoed by Moody's who told us that it would "remove any inducement" for the market "to react disproportionately to changes in ratings".⁹⁴ We came to the same conclusion when we previously considered this issue in our report *The future of EU financial regulation and supervision*, and recommended that "as far as possible the Commission should remove the reliance on ratings for regulatory purposes, in conjunction with similar changes to the Basel rules".⁹⁵
62. We were pleased to note that some progress has already been made in the regulatory sphere. In October 2010, with the support of the G20 Finance Ministers, the Financial Stability Board issued a report entitled *Principles for Reducing Reliance on CRA Ratings*, tasking standard setters and regulators to consider what practical steps could be taken to reduce a reliance on ratings in law and regulations. Meanwhile, Mr Taylor informed us that "in the US ... the move to take ratings out of regulation is clear and is under way"⁹⁶ since

⁸⁷ Q 136

⁸⁸ Q 45

⁸⁹ CED 4, 2, 12

⁹⁰ Q 121

⁹¹ CED 14

⁹² CED 1, 4, 13, 14 and QQ 27, 133, 136

⁹³ Q 136

⁹⁴ CED 6

⁹⁵ Lords European Union Committee, *The future of EU financial regulation and supervision*

⁹⁶ Q 26

“the main emphasis of Dodd-Frank⁹⁷ ... was to remove the reference to credit rating agencies in all regulation there”.⁹⁸

63. The Minister did sound a note of caution, however, that removing references to ratings in legislation was not “the panacea to all evils”.⁹⁹ Indeed, he told us that “I do not think we can remove excessive reliance entirely, because there are circumstances where you want that objective, independent measure to give certainty and consistency about regulatory approach”.¹⁰⁰ The most recent revision of the Basel Accords for example, the Basel III rules, continues to provide ratings with a key role in banking regulation. These were agreed in December 2010, despite international agreement that the use of ratings in regulation should be reduced as far as possible.
64. The means to change investors’ behaviour so that ratings are no longer used as ‘triggers’ in investment mandates or private contracts are less clear. The ECB has suggested that a “flexibility clause” could be introduced, allowing the boards of institutions to decide to deviate from the risk level approved in their guidelines if necessary. It adds, however, that this flexibility should not come “at the expense of adequate risk protection”.¹⁰¹ The Government suggests that “financial institutions improve their risk management processes and apply more judgement in the way in which they use rating information”,¹⁰² while the IMA suggests “a challenge to the investment consultant consensus on inserting such definitions” would help reduce a mechanistic response to rating changes.¹⁰³
65. **We continue strongly to support international efforts to reduce the role that credit ratings play in regulations, investment mandates and private contracts. This ‘hard-wiring’ of ratings leads to a mechanistic reaction to rating changes which may cause cliff-edge effects, herd behaviour among investors and systemic disruption.**

The financial crisis vs the euro area crisis

66. When criticism has been levelled at the rating agencies over the course of the euro area crisis it has often referred to their role in the financial crisis. The Greek government, for example, published a statement after Moody’s downgraded their credit rating stating that “having completely missed the build-up of risk that led to the global financial crisis in 2008, the rating agencies are now competing with each other to be the first to identify risks that will lead to the next crisis”.¹⁰⁴
67. Although we have not considered the issue in detail in this report, we recognise that the behaviour of CRAs during the financial crisis in 2008 raised serious concerns about the accuracy of their ratings of structured financial products and conflicts of interest that may have arisen when making

⁹⁷ See paragraph 8

⁹⁸ Q 27

⁹⁹ Q 143

¹⁰⁰ Q 143

¹⁰¹ ECB, *Eurosystem response to Commission consultation on credit rating agencies*, paragraph 1.2.

¹⁰² CED 1

¹⁰³ CED 2

¹⁰⁴ Hellenic Republic Ministry of Finance, Announcement regarding Moody’s downgrading of the Greek sovereign debt rating, March 2011

those ratings. These valid concerns, however, should not influence perceptions of the behaviour of rating agencies in the euro area crisis.

68. The Minister told us that it was important to distinguish between the two instances: “[while] we saw a problem, particularly in the area of structured products ... we have not seen a problem to the same extent in either the rating of sovereign debt or straightforward corporate debt”.¹⁰⁵ Ms Ridpath concurred: “less educated investors or commentators tend to confuse the two”.¹⁰⁶ Both the Minister and Ms Ridpath suggested that CRAs had in fact not performed badly in relation to sovereign debt.¹⁰⁷
69. **The credit rating agencies have come in for deserved criticism for their ratings of structured financial products in the run-up to the 2008 world financial crisis. Their role in the euro area crisis, however, has been substantially different and anger over their failures in the financial crisis should not be allowed to colour objective assessments of their current decisions relating to EU sovereign debt.**
70. **In our view, the valid charge against the rating agencies is not that they precipitated or exacerbated the euro area crisis, but that they conspicuously failed to identify the mounting risks in some Member States. We call on the rating agencies to draw appropriate lessons from this failure, and to seek to improve their performance in future. We hope also that the markets will subject the views of credit rating agencies to more rigorous scrutiny in light of this failure. Responsibility for investment decisions ultimately lies with investors, and they should bear in mind the principle of *caveat emptor* when deciding how much reliance to place on the judgement of rating agencies.**

¹⁰⁵ Q 141

¹⁰⁶ Q 74. See also Q 58

¹⁰⁷ QQ 74, 136

CHAPTER 4: A EUROPEAN CREDIT RATING AGENCY?

71. The on-going euro area crisis and the resultant blame placed on credit rating agencies (see Chapter 3) have led to calls for the EU to support, or create, competitors to the big three rating agencies.¹⁰⁸ We discuss the nature of the current market and the issue of competition in the credit rating industry first, before turning to consider various suggestions that have been put forward for some form of a ‘European credit rating agency’.

The current structure of the market

72. At present, “the majority of ratings are issued by a few global CRAs with multiple subsidiaries and branches internationally”.¹⁰⁹ Currently, only the ‘big three’ agencies operate globally. This is a relatively recent development; until ten years ago there were only two global credit rating agencies, Moody’s and Standard and Poor’s. Mr Taylor described how Fitch came into being a decade ago from “a combination of a group of smaller agencies”. He noted that, although Fitch was now indeed a global agency it was only “about 40% of the size of S&P and Moody’s. They have significantly more dominance in credit ratings than us”.¹¹⁰ Given the dominance of three large agencies, the market is clearly a *de facto* oligopoly at present,¹¹¹ and indeed, Fitch argued that currently the industry was a “duopoly” since S&P and Moody’s “are virtually omnipresent in the investment guidelines of investors”.¹¹²
73. In addition to the three global agencies there are a number of smaller agencies. Mr Taylor said that there are “100+ rating agencies in the world”.¹¹³ EACRA noted that “the three US agencies dominate the rating market when looked at a global level only ... next to these agencies several local players exist and have a strong market position in their respective fields” although it noted that such agencies “lack visibility on a European or global basis”.¹¹⁴ To date over 20 organisations have applied to be registered as credit rating agencies in Europe.¹¹⁵ It is worth noting, however, that the ‘big three’ agencies account for more than 90% of the credit rating market.¹¹⁶

A US bias?

74. The big three rating agencies all originated in the US market, although Fitch is now majority-owned by a French company.¹¹⁷ This has given rise to accusations that they have an ‘Anglo-Saxon bias’ and do not understand the construction of European economies. Mr Jose Manuel Barroso, President of the European Commission, was recently quoted as saying that “it is quite strange that the market is dominated by only three players and not a single

¹⁰⁸ See, for example, Spiegelonline, *Europe Seeks to Free Itself from Rating Agencies’ Grip*, July 2011

¹⁰⁹ CED 1

¹¹⁰ Q33

¹¹¹ Q124, CED 13

¹¹² CED 8. See also CED 10

¹¹³ Q 33

¹¹⁴ CED 11

¹¹⁵ CED 6, 11

¹¹⁶ OECD, *Hearing on Competition and Credit Rating Agencies*, June 2010

¹¹⁷ Q 41

agency coming from Europe. It shows there may be some bias in the market when it comes to evaluation of issues in Europe”.¹¹⁸ Mr John Chapman, a former UK civil servant and diplomat and a journalist for the Financial Times, told us that “it is wrong that US-based CRAs should have a monopoly over the rating of sovereign debts of European countries”.¹¹⁹

75. Ms Ridpath thought there might be some “inherent bias” since “financial analysis is a largely Anglo-Saxon methodology”, but noted that it has spread largely through European investors and financial institutions “to a much broader basis of analysis than it used to be”.¹²⁰ Mr Drevon conceded that “there may be an overall Anglo-Saxon bias to credit analysis, because it was developed in the Anglo-Saxon world”, but he joined other witnesses in roundly dismissing the claims.¹²¹ Dr Klinz, for example, told us that “you can say they have made many mistakes but the fact is that they do, I think, have a pretty good understanding of the European set up”,¹²² while Dr Blundell-Wignall stated that there was “certainly not” a US bias.¹²³
76. The CRAs pointed out that most of their staff working on European sovereign debt were themselves European,¹²⁴ while Mr Taylor stated bluntly that these accusations came from “the European mentality of ‘They don’t understand us’; i.e. they are not rating us highly enough”. He concluded that “it is simply not true”.¹²⁵
77. It is worth emphasising that, although they may share many similarities, methodologies differ across CRAs. EACRA confirmed that “CRAs enjoy full independence on these methodologies as long as they are applied consistently and continuously, so methodologies differ” as does the “weighting of the different factors too”. EACRA added, however, that methodologies tended to converge “to a perceived best practice of few players, leaving less room to alternative approaches and assessments”.¹²⁶
78. We recognise that our witnesses in general dismissed suggestions that CRAs have some form of US or Anglo-Saxon bias. We note, however, that rating agencies with a background in developing economies may develop a different approach towards ratings. Dr Ryan, for example, noted that Dagong, China’s leading credit rating agency, gives much more relevance to “wealth creating capacity” and foreign reserves than big three western CRAs.¹²⁷ Ms Ridpath agreed: “they have opted for a very different approach, which is to emphasise future growth as opposed to existing wealth and existing ability to pay debt”.¹²⁸ Mr Chapman commented that Dagong’s approach to sovereign debt ratings showed “that different judgements can be made” and may also suggest “that others from different power blocs may produce new ratings”.¹²⁹

¹¹⁸ Euobserver.com, *Barroso to ratings agencies: ‘We know better’*, July 2011

¹¹⁹ CED 9

¹²⁰ Q 104

¹²¹ Q 14

¹²² Q 123

¹²³ Q 60

¹²⁴ QQ 14, 16

¹²⁵ Q 15

¹²⁶ CED 11

¹²⁷ CED 10

¹²⁸ Q 84

¹²⁹ CED 9

79. **We received little evidence to support suggestions that the big three rating agencies approach EU sovereign ratings with a US bias. We note, however, that different approaches to credit rating are emerging from outside western financial markets. We welcome this development.**

Is greater competition desirable?

80. European leaders have expressed concern about the oligopolistic nature of the credit rating market, and suggested that greater competition is needed in the industry. The German Finance Minister, Wolfgang Schaeuble, stated in July 2011 for example that he wanted “to break the oligopoly of the rating agencies”.¹³⁰
81. Several of our witnesses supported greater competition and suggested a number of potential benefits. The IMA argued that “more competition would help to increase the quality of credit ratings”,¹³¹ while Feri EuroRating Services, a Germany-based European rating agency, suggested that the existence of “more agencies with different opinions” would help “limit the market volatility”.¹³² Mr Drevon told us that “competition around pricing is always a good initiative. Competition on standards is a good thing if it improves standards”.¹³³ The Government stated that they were in favour of promoting competition, arguing that “the relative lack of competition in the industry may contribute to the high prices charged by CRAs and discourage innovation in the provision of credit ratings”.¹³⁴
82. There are, however, potential downsides to increased competition. The Minister described how competition could pose a risk “if there is a race to the bottom ... in this case a race to triple-A rating” where “agencies suspend their judgement in order to compete with each other”.¹³⁵ Ms Ridpath gave the view of an industry insider:
- “what concerns me in the competitive arguments for rating agencies is what caused some of the problems in securitisation, which is competition on criteria and competition to give the best rating in the interest of the issuer, not of the investor”.¹³⁶
- She added that, while at S&P, she “saw new entrants who often gave higher ratings to gain market share”.¹³⁷
83. This concern was confirmed by Mr Drevon who told us that “rating shopping was a very apparent phenomenon in the structured finance universe”, although he felt that “post-2007, the quality of the work coming out from the industry has improved”.¹³⁸

¹³⁰ BBC News, *Rating Agencies criticised by European Commission*, July 2011

¹³¹ CED 2

¹³² CED 5

¹³³ Q 33

¹³⁴ CED 1

¹³⁵ Q 159. See also CED 9

¹³⁶ Q 77

¹³⁷ Q 78

¹³⁸ Q 35. See also CED 14

84. Not everyone agreed that the quality of ratings had suffered before the financial crisis. Mr Taylor, for example, thought that concerns about rating shopping were exaggerated: “you can make the numbers say what you want them to say. We have just been through a financial crisis. It is quite easy to say that rating quality has declined”.¹³⁹ Mr Beers commented that he had not seen much rating shopping in the sovereign markets, although he did not comment on CRAs’ wider activities.¹⁴⁰
85. The ICFR summarised the dilemma posed by increased competition: “while in practice, more competition in ratings sounds like a good answer, it very much depends on the basis for such competition: product pricing? Who pays? Criteria competition? Higher ratings?”.¹⁴¹ Thus the Minister told us that while the Government support increased competition, it must be done “in a way that ensures the quality of rating is not compromised”.¹⁴²

Barriers to entry

86. The Government strongly supported increasing competition in the industry, but doing so will not be easy. The Government told us that the ratings industry is “highly concentrated and that entry is difficult”.¹⁴³ Witnesses described a number of significant barriers to entry, including high start-up costs¹⁴⁴ and reputational barriers.¹⁴⁵ Ms Barbara Ridpath noted the big firms maintained their position by purchasing successful entrants into the market: “the risk is that as soon as they [new CRAs] get successful, they get purchased”.¹⁴⁶
87. Our witnesses also pointed to the regulatory structure as a barrier to entry. Firstly, their role in regulation means that governmental recognition is essential. Mr Blundell-Wignall described the problem: “one of the main barriers to entry ... is that there are explicit references in some of the regulations of the ratings ... those regulations essentially give you a Government stamp of approval; investors must use these agencies”.¹⁴⁷ Secondly, new regulation being enacted in the wake of the financial crisis is adding new burdens on firms, making it harder and more expensive for new entrants to comply.¹⁴⁸ Dr Blundell-Wignall, for example, pointed specifically to “the fairly onerous registration requirements, endorsement requirements and local presence requirement ... [which] make it very costly” for firms to get a foothold in the EU.¹⁴⁹
88. Several suggestions were made about how to lower or remove the barriers to entry. The Minister presented a strong argument for encouraging comparability to ensure that “the relative performance of credit rating

¹³⁹ Q 37

¹⁴⁰ Q 35

¹⁴¹ CED 13

¹⁴² Q 136

¹⁴³ CED 1. See also Q 51, CED 2

¹⁴⁴ Q 42, CED 1

¹⁴⁵ CED 1, QQ48, 99

¹⁴⁶ Q 88

¹⁴⁷ Q 51

¹⁴⁸ QQ 33, 38, 39

¹⁴⁹ Q 51

agencies is capable of analysis”.¹⁵⁰ He thought that this would show “that actually the existing agencies are not very good at rating particular products ... what we would see [develop] is: not so much four big rating agencies but a number of specialist and niche rating agencies that exploit weaknesses in existing models of rating agencies”.¹⁵¹ Mr Drevon took a similar line, stating that he would improve disclosure standards and require issuers to publish their information “to enable a new player to ... develop their own views about credit and publish those views”.¹⁵²

89. HM Treasury suggested two further ideas. Firstly, they proposed reducing the hardwiring of ratings in regulation to remove the “semi-official status afforded to incumbent CRAs”. Secondly, they argued that the new requirements of EU legislation (see Chapter 5) may help reduce the reputational barriers to entry by acting as a partial substitute for a track record of accurate judgements.¹⁵³ EACRA agreed that EU regulation will ensure that “registered CRAs will deliver ratings at the expected quality level”.¹⁵⁴
90. Witnesses also suggested that a ‘platform pays’ model could be used as a means to increase competition and reduce conflicts of interest.¹⁵⁵ Under this model, issuers are allocated a credit rating agency by a neutral third-party body, rather than choosing one themselves. A variation on this proposal is to have issuers pay for two ratings: one from a CRA of their choice, and one from a CRA allocated by a neutral third party. Both of these schemes would be intended to increase competition since the neutral third-party assigning the ratings would allocate ratings to smaller agencies as well the ‘big three’ CRAs. In addition, it is expected it would reduce conflicts of interest since CRAs would be randomly allocated to issuers. Dr Blundell-Wignall told us he was “in favour of the ... ‘platform pays’ model”.¹⁵⁶
91. None of the proposals above, however, present a clear cut solution to concerns about a lack of competition in the credit rating industry. Open Europe stated baldly that “more competition is clearly needed, but there is no obvious way to increase it”.¹⁵⁷

A European solution?

92. Support has been growing for the EU to fund, or encourage, some type of European credit rating agency, both to increase competition in the sector and to combat the perceived US bias of the ‘big three’ rating agencies. A number of ideas have been suggested.

A publicly-funded EU Credit Rating Agency

93. One suggestion in the Commission’s consultation is the establishment of a European Credit Rating Agency, whose start-up costs could be “wholly or

¹⁵⁰ Q 159

¹⁵¹ Q 160

¹⁵² Q 38

¹⁵³ CED 1. See also Q 40

¹⁵⁴ CED 11

¹⁵⁵ See chapter 5 for more detail on conflicts of interest.

¹⁵⁶ Q 49

¹⁵⁷ CED 14

partially covered by the public sector” although over time “public investment could be phased out”.¹⁵⁸ Dr Ryan went further and suggested the creation of a “part publicly-funded pan-European independent agency”.¹⁵⁹

94. The idea received some support from our witnesses. Mr Drevon told us that Moody’s was not opposed to the idea as long as European CRA “operated on a level playing field and was subject to similar regulation to the existing rating agencies”.¹⁶⁰ Mr Chapman thought that a European agency could “act as a counter to US influence. It could adopt a more measured approach to ratings, and so render much speculation redundant”. In addition, “as a body under public control”, a European CRA “could make more appropriate political judgements”.¹⁶¹
95. There are, however, some substantial concerns about this proposal. Mr Beers told us that “there would be obvious questions about the independence of an institution that was sponsored by the European Union governments”.¹⁶² Dr Annunziata expanded on this point:
- “because of the context in which it was first proposed, there is an obvious risk that this would be perceived as aimed at establishing an agency that would be more lenient in assessing the creditworthiness of EU issuers. This would fatally undermine the institution’s credibility from the start”.¹⁶³
96. EuroRating Services were concerned that a state-owned or supported agency would edge out smaller agencies operating in niche markets.¹⁶⁴ The Minister put forward another reason, arguing that the fact that people would place too much trust in a publicly-funded body would “reinforce” an over-reliance on ratings, “rather than reduce it”.¹⁶⁵

An independently-funded EU Credit Rating agency

97. A recent report by the European Parliament Committee on Economic and Monetary Affairs called for the European Commission to investigate “the possibility of establishing a fully independent non-public European Credit Rating Foundation (ECRaF)”, whose start-up costs could be financed for the first three to five years.¹⁶⁶ The rapporteur for the report, Dr Klinz, made clear that these start-up costs “should not be financed by the public sector ... they should be financed by the financial community in the form of credits that will yield some interest payment”.¹⁶⁷ Ms Ridpath was “supportive” although “slightly pessimistic as to the likelihood of success” given the need for successful agencies to have a track record of accurate ratings.¹⁶⁸ The

¹⁵⁸ European Commission, *Public consultation on credit rating agencies*, paragraph 3.3

¹⁵⁹ CED 10

¹⁶⁰ Q 41

¹⁶¹ CED 9

¹⁶² Q 43. Other witnesses also raised these concerns. See, for example, Q60, CED 4, 14

¹⁶³ CED 12

¹⁶⁴ CED 5. See also CED 7

¹⁶⁵ Q 172. See also Q 43

¹⁶⁶ European Parliament Committee on Economic and Monetary Affairs, *Report on credit rating agencies: future perspectives*, 23 March 2011 (A7-0081/2011)

¹⁶⁷ Q125

¹⁶⁸ Q 99

Minister was unconvinced: “I am not sure I could be persuaded ... my concern would be: would there be an appetite for a fourth player? If there was an appetite, why is the market not coming forward with money to fund it?”¹⁶⁹

A network of CRAs

98. There was more support for encouraging the growth of existing small credit rating agencies. Dr Klinz suggested that the EU “should also encourage the existing national and regional credit rating agencies in the various European Member States to maybe work more closely together, form a kind of European network” to help them build an international base.¹⁷⁰ The Minister again expressed scepticism, arguing that “if there are seas of niche players out there who would feel that together they could be a fourth force in credit rating ... that would be a good thing, but I do not think we should be directing a market in any particular route”.¹⁷¹
99. Several witnesses, however, suggested encouraging established CRAs in other parts of the world. Ms Ridpath thought that encouraging “agencies in emerging markets is a very good idea”,¹⁷² while Dr Blundell-Wignall pointed to “a lot of Asian-based rating firms that could easily be involved in the process of rating within Europe”¹⁷³ if the barriers to entry were lower. Dr Klinz also noted that “there are also rating agencies in Canada, in Japan, in Brazil, and so on. We should encourage them to also work in Europe, provided that they do accept and respect our underlying rules and meet our underlying criteria”.¹⁷⁴
100. **There is a compelling argument for a thorough competition inquiry into the structure and regulation of the credit rating industry. This inquiry should consider the full range of ideas proposed to increase competition in the sector, including those outlined above.**
101. **It is clear, however, that the EU should not fund, either initially or in the long-term, a credit rating agency. An EU-sponsored credit rating agency would lack credibility with the markets which would assume that EU governments would have undue influence over its decisions.**

The IMF and OECD: what role in sovereign ratings?

102. Concerns have been expressed about private listed companies wielding influence over, and passing judgement on, the economic situation of sovereign nations. Mr Chapman observed that the “rating of sovereign debt involves a great number of economic factors, but ultimately political judgements; it is wrong that such judgements should be left to commercial organisations”.¹⁷⁵ Mr Jurgen Klute MEP stated in a recent interview that the CRAs “are granted the role of referee when, at the same time, they are also players in the financial playing field”.¹⁷⁶

¹⁶⁹ Q 174

¹⁷⁰ Q 135

¹⁷¹ Q 173

¹⁷² Q 87

¹⁷³ Q 51

¹⁷⁴ Q 135

¹⁷⁵ CED 9

¹⁷⁶ Europarl interview with Jurgen Klute MEP, *Rein in the rating agencies, says Jurgen Klute*

103. In light of these concerns, we considered whether independent, non-profit, organisations such as the IMF or the OECD were better placed to provide an assessment of the creditworthiness of sovereign debt.
104. Our witnesses were generally sceptical of the idea. Mr Beers noted that ten years ago, after the Asian crisis, some governments suggested that the IMF should provide credit ratings of sovereign nations and the IMF decided against it. He provided two possible reasons for this decision: firstly, it “created a very real conflict for them, since they are an institution that lends money”; and secondly, “their constituencies and their effective owners are the Governments themselves”.¹⁷⁷
105. Dr Blundell-Wignall agreed that the IMF might face a conflict of interest because it is involved in providing money to the EU: “it could be tempted to err on the side of optimism with some of these countries because not to do so might increase the problem”.¹⁷⁸ The OECD would not face the same conflict, but he noted that it only has 33 member countries. Dr Klinz observed that while the IMF and the OECD were capable of rating countries, their credibility would suffer if something went wrong.¹⁷⁹
106. The Minister opposed giving the IMF a credit rating role. He noted that “it is not always perfect in its own economic analysis. So we should be wary about building up an institution as being the sole source of wisdom and knowledge on these things”.¹⁸⁰ Ms Ridpath told us that her understanding was “that the votes among the board of the IMF on how these decisions get made are also quite political”, a view endorsed by the Minister: “its Governors are Finance Ministers from different Members, and some might argue that an international body like that is more susceptible to political influence than perhaps a credit rating agency would be”.¹⁸¹
107. **We recognise the expertise of the IMF and OECD, and we believe that information from these two organisations, and particularly from the IMF, should be considered influential sources of information by investors. Assigning either of these organisations a more formal role in assessing the creditworthiness of sovereigns, however, would encounter significant conflicts of interest. We do not believe, therefore, that either of them should issue sovereign debt ratings.**

¹⁷⁷ Q 17

¹⁷⁸ Q 53

¹⁷⁹ Q 130

¹⁸⁰ Q 168

¹⁸¹ Q 169

CHAPTER 5: THE REGULATION OF CRAs

EU Regulation

The European Securities and Markets Authority

108. In 2008, after concerns were raised about the role of credit rating agencies in the financial crisis, the European Commission proposed a Regulation establishing harmonised EU-wide rules for CRAs. Regulation (EC) No 1060/2009 on credit rating agencies was subsequently adopted in 2009. The Regulation requires all CRAs to register in the EU and to disclose the models, methodologies and assumptions on which they base their ratings. In addition, it introduced restrictions on rating agencies' provision of advisory services.¹⁸² Mr Alexander Justham, Director of Markets at the Financial Services Authority (FSA), described how the Regulation is intended to ensure that "the conflicts of interest, the systems of control, the governance and the way these ratings are created are appropriate and properly executed".¹⁸³
109. In 2009 Member States took the decision to place CRAs under the direct supervision of the soon-to-be-created European Supervisory Authorities, with the expectation that EU supervision would improve the effective oversight of CRAs that operate across borders. It would also mean that rating agencies would no longer have to deal with multiple supervisors.¹⁸⁴ Mr Justham informed us that the FSA is currently preparing to hand over responsibility for the regulation of CRAs to the European Securities and Markets Authority (ESMA) in July 2011. He noted that CRAs will be the first financial institutions to be regulated directly at an EU level, a "significant change".¹⁸⁵
110. The rating agencies told us they were positive about ESMA's new role. Mr Drevon thought that the new regulatory regime would increase EU policy-makers' confidence in the way CRAs operate and provide a more "consistent approach" to regulation.¹⁸⁶ Mr Taylor, meanwhile, welcomed the ability to deal with a single regulator instead of "a dozen different parties".¹⁸⁷
111. Nevertheless, it is early days. Mr Justham identified two key challenges for ESMA: first, it will have "to juggle and balance" its regulation of small, local rating agencies with that of the 'big three' global agencies. Secondly, while ESMA will have the formal responsibility to regulate CRAs, it is unclear to what extent it will rely upon the manpower and resources of national regulators to carry out this role.¹⁸⁸

¹⁸² The Committee's 2009 report on *The future of EU financial regulation and supervision* examined the Regulation on credit rating agencies as part of the EU legislative proposals in response to the 2008 financial crisis.

¹⁸³ Evidence session with officials from the FSA, published with a report from the European Union Committee, *The EU Financial Supervisory Framework: an update*, 20th Report (2010–12), HL 181, Q 42.

¹⁸⁴ See the Committee's forthcoming report *EU financial supervisory framework: an update*, and *Correspondence with Ministers, May 2010 to December 2010* (<http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubAMay-Oct10.pdf>)

¹⁸⁵ European Union Committee, *The EU financial supervisory framework: an update*, Q 42

¹⁸⁶ Q 25

¹⁸⁷ Q 26

¹⁸⁸ European Union Committee, *The EU financial supervisory framework: an update*, Q 42

112. The Minister noted that “one of the lessons we should learn from the last financial crisis was a failure of regulation and supervision to keep pace with market developments”. He was clear, therefore, that the regulatory framework for CRAs was still a “work in progress” which would remain under review.¹⁸⁹ In particular, he noted that while Europe was in “the driving seat”, the UK should “continue to influence the regulation and make sure it is proportionate to the risks that have been indentified”.¹⁹⁰
113. The IMA did suggest that the EU regulatory framework for CRAs had only been implemented recently, and “should be allowed time so that its effectiveness can be monitored”.¹⁹¹ Likewise, a joint submission from the Association for Financial Markets in Europe and the British Bankers Association argued that further changes “should only be made once there has been sufficient time to reflect upon and meaningfully assess the impact of recent changes upon CRAs”.¹⁹²
114. **We welcome the EU-level regulation of credit rating agencies given their cross-border activities and impact. We recognise, however, that ESMA has only just taken over the direct regulation of credit rating agencies and that the full impact of supervising CRAs under a new regulatory system at an EU level has yet to be determined. While we welcome the Minister’s assurance that the new regulatory framework for CRAs will remain under review, the legislation should be given time to bed down, and its effectiveness assessed, before further changes are made.**

Transparency

115. The UK authorities have argued that it is important that investors understand the methodologies being used by rating agencies. The Minister argued that ratings relied on “a degree of judgement and common sense ... which perhaps makes them less transparent”.¹⁹³ Increasing transparency would help make CRAs more accountable to their users, and “will encourage due diligence and more sophisticated use of CRA ratings by investors”.¹⁹⁴ Ms Ridpath strongly supported the Minister’s stance, stating that increased transparency would do “an enormous good”,¹⁹⁵ although she noted that already CRAs were “very transparent ... they do not conceal their rationale or their methodologies from anybody”.¹⁹⁶
116. Mr Beers told us that S&P’s criteria and methodologies for sovereign ratings have been in the public domain for many years so that market participants “have a better understanding of the type of factors that we look at”.¹⁹⁷ S&P were currently updating their sovereign rating methodology and their objective was to make it “more transparent still”.¹⁹⁸

¹⁸⁹ Q 151

¹⁹⁰ Q 142

¹⁹¹ CED 2

¹⁹² CED 3

¹⁹³ Q 137

¹⁹⁴ Q 136

¹⁹⁵ Q 77

¹⁹⁶ Q 93

¹⁹⁷ Q 5

¹⁹⁸ Q 5

117. Fitch was positive about the effects of the recent EU Regulation on CRAs which increased transparency: “the increased transparency around credit ratings now required under the EU Regulation will greatly assist investors in treating credit ratings as one input into their investment analysis”.¹⁹⁹ EACRA warned, however, that stricter transparency requirements on top of this legislation would entail additional administrative costs with doubtful benefits as only highly professional users of ratings would be able to interpret the additional information.²⁰⁰
118. **We recognise the importance of ensuring that the methodologies by which agencies produce their sovereign ratings are transparent, and we would support further initiatives in this area. As we note above, however, the effectiveness of recent legislation should be assessed before further changes are considered.**

International regulation

119. Although we welcome the EU-level supervision of CRAs, our witnesses suggested that regulatory harmonisation at an EU level was not sufficient, given the global nature of financial markets in which investors work across borders on a daily basis.²⁰¹ Ms Ridpath, for example, told us that “this is one industry, more than most others, where I believe the regulation should be international”.²⁰² Mr Taylor indicated that in his view, while increased coordination at an EU level was welcome, “the bigger challenge we have as an industry is trying to get some global consistency and coordination to regulation”.²⁰³
120. Mr Justham told us that: ““it probably only makes sense, when you look at agencies that operate on a global basis, to try and have a degree of harmonisation at an EU level, or most desirably at a global level, to be honest”.²⁰⁴ It is clear that efforts should be made to ensure that regulatory systems converge as quickly as possible. We heard that the Financial Stability Board, founded by the G20 in 2009 to promote financial stability, would be the most suitable place to address the issue of CRA regulation at an international level.²⁰⁵
121. **We recommend that the Government use the Financial Stability Board to push for international agreement on the regulation of credit rating agencies. Given their role regulating credit rating agencies in the EU, the European Securities and Markets Authority should be closely involved in this work.**

Civil liability

122. The Commission’s consultation raises the issue of the civil liability of credit rating agencies. Our questions to witnesses on the civil liability of rating agencies raised two different issues: first, whether CRAs should be liable for

¹⁹⁹ CED 8

²⁰⁰ CED 11

²⁰¹ CED 1, Q 63

²⁰² Q 79

²⁰³ Q 26

²⁰⁴ European Union Committee, *The EU financial supervisory framework: an update*, Q 42

²⁰⁵ CED 1, QQ 63, 81

the accuracy of their ratings; and secondly, whether CRAs should be held responsible for producing those ratings in a responsible and appropriate manner in a harmonised manner across Member States.

123. EuroRating Services told us bluntly that ratings are “probability statements [that] can neither be verified nor falsified”.²⁰⁶ Trying to penalise CRAs for an incorrect rating therefore “fundamentally misunderstands the nature of credit analysis”.²⁰⁷ Mr Drevon told us that if CRAs were liable for whether ratings were “right or wrong” it was not clear how they might react:

“Would we become more conservative to reduce potential risk, and therefore downgrade everything that we can? Would we try to be more aligned with the market ... [so] we cannot be picked out as an outlier and therefore exposed to liability risk? We may decide that we do not want to be involved in certain parts of the financial markets because of greater liability risks”.²⁰⁸

124. Other witnesses agreed that such a proposal could have a detrimental effect on the industry²⁰⁹ and that it was more appropriate to allow the market to hold CRAs to account for the reliability of their ratings.²¹⁰ The Government noted that “formulating a regime of civil liability would present a formidable range of obstacles to which there is no obvious solution”.²¹¹
125. Dr Klinz, however, suggested a different tack: “I am not saying that a credit rating agency should be responsible for the rating it has developed, say, six, 12 or 18 months after the development of the rating ... but the rating agencies should be held accountable for developing the rating in a professional manner. If there is gross negligence then I think there should be a liability that kicks in”.²¹² At present, each Member State has its own national laws in this area. The European Parliament has therefore proposed that “CRAs exposure to civil liability in the event of gross negligence or misconduct be defined on a consistent basis across the EU”.²¹³
126. Ms Ridpath informed us that at present CRAs were subject to domestic civil liability in individual Member States, which worked “as quite a good protection”.²¹⁴ The Minister clarified that “under UK civil law, CRAs can be made liable for negligence or intent”, as was “appropriate”.²¹⁵ He was not aware, however, of “any evidence to suggest there is a problem about the lack of harmonisation”. In his estimation, it was not a problem in search of a solution.²¹⁶
- 127. We do not believe that credit rating agencies should be held legally responsible for the accuracy of their ratings. As is the case at present,**

²⁰⁶ CED 5

²⁰⁷ Q 33 (Mr Beers). See also CED 2, 6, 7, 8, 12

²⁰⁸ Q 32

²⁰⁹ Q 33, CED 4, CED 11

²¹⁰ CED 2, 6,

²¹¹ CED 1

²¹² Q 128

²¹³ European Parliament Committee on Economic and Monetary Affairs, *Report on credit rating agencies: future perspectives*

²¹⁴ Q 83

²¹⁵ Q 153

²¹⁶ Q 154

however, they should be held responsible for negligence or misconduct when producing those ratings. Member States are currently responsible for deciding on the nature of this liability, and we do not, at the present time, believe that a convincing case has been made for the need for a harmonised standard of civil liability across the EU.

Conflicts of interest

128. The credit rating industry operates on an ‘issuer-pays’ model at present, in which issuers pay CRAs to rate their debt or financial products. Many of our witnesses suggested that this payment model presents CRAs with an obvious conflict of interest and pointed to the high ratings that CRAs gave to structured financial products before the financial crisis.²¹⁷ Open Europe summed up the views of many witnesses when they told us that:

“CRAs issued overly optimistic ratings on securitised assets, particularly relating to subprime mortgages ... There is a suggestion that higher ratings may have resulted from conflicts of interest which arose between CRAs and the banks selling these securities. The CRAs got well paid for rating and structuring these assets and therefore had a large incentive to maintain the business and rate them highly”.²¹⁸

129. Not everyone saw the ‘issuer-pays’ model as a problem. Ms Ridpath, for example, argued that it was not in the interests of a CRA to over-rate a product because “ultimately it would impact upon their reputational risk”.²¹⁹

130. Although CRAs have a reputational incentive to rate products correctly—as the Minister stated, ratings shopping is “a very short-term approach”²²⁰—it is clear that structured financial products were over-rated in the run-up to the financial crisis, and it seems that the ‘issuer-pays’ model was at least partly responsible.

131. However, our witnesses indicated that conflicts of interests are far less pronounced in the sovereign debt sphere. First, the rating agencies provide a number of unsolicited sovereign ratings. Moody’s, for example, told us that they provide seven unsolicited ratings to EU sovereigns. The IMA told us that “the sovereign rating tends to be a loss leader and to the extent that it is paid for it comes from subscribers to the ratings service” and concluded that “this could be argued to be a less conflicted structure than that where the corporate pays and could have undue influence over the rating”.²²¹ Secondly, CRAs’ assessment of sovereign debt is generally based on public information. As Dr Annunziata stated, “this provides an easier check on the robustness of the ratings ... [and] in turn helps mitigate the conflict of interest”.²²²

132. The Government agreed: “it is not clear that a ‘sovereign-pays’ model creates a significant conflict of interest ... the issue of CRAs being influenced via remuneration by sovereigns is not one that has been raised. We therefore do not believe this to be an important consideration in CRA reform”.²²³

²¹⁷ Q 134, CED 10, 12, 14

²¹⁸ CED 14

²¹⁹ Q 96

²²⁰ Q 159

²²¹ CED 2

²²² CED 12

²²³ CED 1. See also CED 14

133. **We do not believe that the ‘issuer-pays’ model presents a significant conflict of interest in relation to the rating of sovereign debt. It is, however, a significant issue with regard to the rating of corporate debt and financial products and one that deserves further, more detailed, consideration.** We consider that responsibility for such work would more appropriately lie with the House of Lords Economic Affairs Committee.

Giving sovereigns more advance warning of ratings

134. The Commission’s consultation suggested that sovereigns could be informed three days ahead of the publication of a CRA rating rather than the usual 12 hours. It suggests this would give Member States extra time to check for factual errors and to draw the CRAs’ attention to any new developments which may affect the rating.²²⁴
135. Our witnesses universally opposed this suggestion. They suggested that it would risk sovereigns placing undue influence on the rating agencies²²⁵ and that the additional time would increase the risk that the information would be leaked.²²⁶ We noted with interest, however, that the ECB, in its response to the Commission’s consultation, supported this proposal.²²⁷
136. The Government stated that this proposal “increases the risk of sovereigns seeking to influence the CRA to alter its opinion”. In addition, they warned that it might allow a sovereign to take action to pre-empt the rating announcement.²²⁸
137. **We do not believe that rating agencies should have to inform sovereigns three days in advance of publishing their ratings. It increases the risk that sovereigns will place undue pressures on rating agencies to change their opinion, as well as making it more likely that the information will leak in advance of the rating agencies’ official announcement. We recommend that the status quo, that is that sovereigns get 12 hours advance notice of the publication of ratings, should remain.**

²²⁴ European Commission, *Public consultation on credit rating agencies*

²²⁵ CED 4, 5, 6, 7

²²⁶ CED 5, 6, 7, 8, 13

²²⁷ ECB, *European Commission’s Public Consultation on Credit Rating Agencies—Eurosystem Reply*, February 2011

²²⁸ CED 1

CHAPTER 6: SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Chapter 2: Sovereign debt and ratings

Sovereign ratings

Are sovereign ratings necessary?

138. Sovereign ratings can play a useful role that contributes to the smooth and efficient working of the worldwide sovereign debt market. We note that sovereign ratings play a significant role in determining the cost to a government of borrowing money (para 22).

Sovereign rating methodologies

Assessing the future: the subjective nature of ratings

139. We recognise that sovereign ratings involve a mix of quantitative and qualitative assessments. They are not the result of a mechanistic process, but ultimately subjective views relying heavily on the judgement of the rating agencies. Investors should not rely solely on sovereign ratings as an authoritative indicator of creditworthiness, but view them as opinions that need to be balanced and confirmed by other market indicators (para 33).

Unsteady foundations

140. In our report, *The future of Economic Governance in the EU*, we concluded that “accurate and comparable statistics are essential if there is to be effective economic coordination between Member States”. We recognise a similar need for accurate national statistics to ensure that the rating agencies present an accurate portrayal of a country’s creditworthiness. We therefore reiterate our recommendation, set out in that report, that the Commission should bring forward legislative proposals to improve the quality of national statistical data and to strengthen further Eurostat’s powers (para 36).
141. While ratings are relied upon by the regulatory framework we believe it is only appropriate that sovereigns should cooperate with credit rating agencies to ensure that their ratings are as accurate as possible (para 37).
142. The idea that credit ratings should be suspended for countries receiving international financial assistance is entirely inappropriate and wholly impractical given that all of the ‘big three’ agencies are headquartered in the US. Furthermore, it smacks of censorship (para 39).

Chapter 3: The euro area crisis

Predicting the crisis

143. The failure of the credit rating agencies to challenge the fundamental assumptions on which their assessment of the sustainability of sovereign debt in the euro area was based meant there was inadequate differentiation between the sovereign debt of individual countries. We recognise that the rating agencies were not alone in failing to fully understand the extent of the

problems developing in certain Member States, but this does not absolve their failure to assess properly the financial health of certain euro area Member States in the run-up to the sovereign debt crisis (para 44).

Precipitating the crisis?

144. We do not believe that the credit rating agencies precipitated the euro area crisis. Their rating downgrades merely reflect the seriousness of the problems that sovereigns are currently experiencing in the euro area and in most cases they have followed, rather than led, market sentiment. In addition, the rating agencies have had to operate against a background of shifting policy initiatives from EU Member States which has complicated their work. We do not believe, therefore, that calls to regulate further credit rating agencies can be justified on the basis of their actions during the euro area crisis (para 52).

Exacerbating the crisis?

145. We recognise that rating changes can have disproportionate effects on the financial markets in certain circumstances. It is not entirely clear, however, that this has happened in the euro area crisis. Given the fast-moving nature of the euro area crisis and the volatility of the financial markets in the aftermath of the financial crisis, we do not believe that it is possible to determine the extent to which rating agencies may or may not have exacerbated the crisis (para 60).
146. We continue strongly to support international efforts to reduce the role that credit ratings play in regulations, investment mandates and private contracts. This ‘hard-wiring’ of ratings leads to a mechanistic reaction to rating changes which may cause cliff-edge effects, herd behaviour among investors and systemic disruption (para 65).

The financial crisis vs the euro area crisis

147. The credit rating agencies have come in for deserved criticism for their ratings of structured financial products in the run-up to the 2008 world financial crisis. Their role in the euro area crisis, however, has been substantially different and anger over their failures in the financial crisis should not be allowed to colour objective assessments of their current decisions relating to EU sovereign debt (para 69).
148. In our view, the valid charge against the rating agencies is not that they precipitated or exacerbated the euro area crisis, but that they conspicuously failed to identify the mounting risks in some Member States. We call on the rating agencies to draw appropriate lessons from this failure, and to seek to improve their performance in future. We hope also that the markets will subject the views of credit rating agencies to more rigorous scrutiny in light of this failure. Responsibility for investment decisions ultimately lies with investors, and they should bear in mind the principle of *caveat emptor* when deciding how much reliance to place on the judgement of rating agencies (para 70).

Chapter 4: A European credit rating agency?

A US bias?

149. We received little evidence to support suggestions that the big three rating agencies approach EU sovereign ratings with a US bias. We note, however,

that different approaches to credit rating are emerging from outside western financial markets. We welcome this development (para 79).

A European solution?

A network of CRAs

150. There is a compelling argument for a thorough competition inquiry into the structure and regulation of the credit rating industry. This inquiry should consider the full range of ideas proposed to increase competition in the sector, including those outlined above (para 100).
151. It is clear, however, that the EU should not fund, either initially or in the long-term, a credit rating foundation. An EU-sponsored credit rating agency would lack credibility with the markets which would assume that EU governments would have undue influence over its decisions (para 101).

The IMF and OECD: what role in sovereign ratings?

152. We recognise the expertise of the IMF and OECD, and we believe that information from these two organisations, and particularly from the IMF, should be considered influential sources of information by investors. Assigning either of these organisations a more formal role in assessing the creditworthiness of sovereigns, however, would encounter significant conflicts of interest. We do not believe, therefore, that either of them should issue sovereign debt ratings (para 107).

Chapter 5: The regulation of CRAs

EU Regulation

The European Securities and Markets Authority

153. We welcome the EU-level regulation of credit rating agencies given their cross-border activities and impact. We recognise, however, that ESMA has only just taken over the direct regulation of credit rating agencies and that the full impact of supervising CRAs under a new regulatory system at an EU level has yet to be determined. While we welcome the Minister's assurance that the new regulatory framework for CRAs will remain under review, the legislation should be given time to bed down, and its effectiveness assessed, before further changes are made (para 114).

Transparency

154. We recognise the importance of ensuring that the methodologies by which agencies produce their sovereign ratings are transparent, and we would support further initiatives in this area. As we note above, however, the effectiveness of recent legislation should be assessed before further changes are considered (para 118).

International regulation

155. We recommend that the Government use the Financial Stability Board to push for international agreement on the regulation of credit rating agencies. Given their role regulating credit rating agencies in the EU, the European

Securities and Markets Authority should be closely involved in this work (para 121).

Civil liability

156. We do not believe that credit rating agencies should be held legally responsible for the accuracy of their ratings. As is the case at present, however, they should be held responsible for negligence or misconduct when producing those ratings. Member States are currently responsible for deciding on the nature of this liability, and we do not, at the present time, believe that a convincing case has been made for the need for a harmonised standard of civil liability across the EU (para 127).

Conflicts of interest

157. We do not believe that the ‘issuer-pays’ model presents a significant conflict of interest in relation to the rating of sovereign debt. It is, however, a significant issue with regard to the rating of corporate debt and financial products and one that deserves further, more detailed, consideration (para 133).

Giving sovereigns more advance warnings of ratings

158. We do not believe that rating agencies should have to inform sovereigns three days in advance of publishing their ratings. It increases the risk that sovereigns will place undue pressures on rating agencies to change their opinion, as well as making it more likely that the information will leak in advance of the rating agencies’ official announcement. We recommend that the status quo, that is that sovereigns get 12 hours advance notice of the publication of ratings, should remain (para 137).

APPENDIX 1: EU SUB-COMMITTEE ON ECONOMICAL AND FINANCIAL AFFAIRS AND INTERNATIONAL TRADE

The Members of the Sub-Committee who conducted this inquiry were:

Lord Harrison (Chairman)
 Lord Hamilton of Epsom
 Lord Haskins
 Baroness Hooper
 Lord Jordan
 Lord Kerr of Kinlochard (from 17 May 2011)
 Baroness Maddock
 Lord Marlesford
 Lord Moser
 Lord Trefgarne (until 21 June 2011)
 Lord Vallance of Tummel
 Lord Woolmer of Leeds

Declarations of Interest

Lord Harrison
None relevant

Lord Hamilton of Epsom
Director Jupiter Dividend & Growth Trust (Investment Fund)
Director IREF Global Holdings (Bermuda) Ltd (Property Fund)
Director IREF Australian Holdings (Bermuda) Ltd (Property Fund)

Lord Haskins
None relevant

Baroness Hooper
None relevant

Lord Jordan
None relevant

Lord Kerr of Kinlochard
Deputy Chairman Royal Dutch Shell plc
Non-executive Director, Rio Tinto plc
Non-executive Director, Scottish Power plc
Non-executive Director Scottish American Investment Co Ltd
Chairman of Court and Council, Imperial College London Chairman, Centre for European Reform (London) Vice President, European Policy Centre (Brussels)
Advisory Board Member, BAe Systems Plc

Baroness Maddock
None relevant

Lord Marlesford
Director of Gavekal Research (Hong Kong)
Advisor to Sit Investment Associates (USA)
Independent National Director Times Newspaper Ltd

Lord Moser
None relevant

Lord Trefgarne
None relevant

Lord Vallance of Tummel

Member Supervisory Board Siemens AG, Member International Advisory Board, Allianz SE

Lord Woolmer of Leeds
None relevant

A full list of registered interests of Members of the House of Lords, including each Member of the European Union Select Committee, can be found at <http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/>.

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at <http://www.parliament.uk/hleua> and available for inspection at the Parliamentary Archives (020 7219 5314)

Evidence received by the Committee is listed below in order of receipt and in alphabetical order. Witnesses without a * gave written evidence only. Witnesses marked with * gave both oral and written evidence. Witnesses marked with ** gave oral evidence and did not submit any written evidence.

Oral evidence in chronological order

- * (Q1–43) Mr Paul Taylor, Fitch Ratings
- * Mr Frederic Drevon, Moody's Investors Service
- * Mr David Beers, Standard and Poor's
- ** (Q44–67) Dr Adrian Blundell-Wignall, Deputy Director in the Directorate for Financial and Enterprise Affairs, and Special Adviser to the Secretary General on Financial Markets, OECD
- * (Q68–120) Ms Barbara Ridpath, Chief Executive, International Centre for Financial Regulation
- ** (Q121–176) Dr Wolf Klinz, Member of the European Parliament
- * Mark Hoban MP, Financial Secretary to HM Treasury and Gary Roberts

Written evidence in order of receipt

- * (CED 1) Mark Hoban MP, Financial Secretary to HM Treasury
- (CED 2) Investment Management Association
- (CED 3) Association for Financial Markets in Europe
- (CED 4) Association of British Insurers
- (CED 5) Euro Rating Services
- * (CED 6) Moody's Investors Service
- * (CED 7) Standard and Poor's
- * (CED 8) Fitch Ratings
- (CED 9) Mr John Chapman
- (CED10) Dr John Ryan (Centre for Economic Policy Analysis, Venice, Italy and German Institute for International and Security Affairs)
- (CED 11) European Association of Credit Rating Agencies
- (CED 12) Dr Marco Annunziata
- * (CED 13) International Centre for Financial Regulation
- (CED 14) Open Europe
- * (CED 15) Moody's Investors Service
- * (CED 16) Standard and Poor's

- * (CED 17) Fitch Ratings

Alphabetical

- Dr Marco Annunziata (CED 12)
- Association of British Insurers (CED 4)
- Association for Financial Markets in Europe (CED 3)
- Mr John Chapman (CED 9)
- Dr John Ryan (Centre for Economic Policy Analysis, Venice, Italy and German Institute for International and Security Affairs) (CED10)
- Euro Rating Services (CED 5)
- European Association of Credit Rating Agencies
- ** Dr Wolf Klinz, Member of the European Parliament
- ** Dr Adrian Blundell-Wignall, Deputy Director in the Directorate for Financial and Enterprise Affairs, and Special Adviser to the Secretary General on Financial Markets, OECD
- * Fitch Ratings (CED 8, 18)
- * International Centre for Financial Regulation (CED 13)
- Investment Management Association (CED 2)
- * Moody's Investors Service (CED 6, 15)
- Open Europe (CED 14)
- * Standard and Poor's (CED 7, 16)
- * Mark Hoban MP, Financial Secretary to HM Treasury (CED 1, 18)

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee, chaired by Lord Harrison, is launching an inquiry into credit rating agencies and their influence on sovereign borrowing. We invite you to contribute evidence to this inquiry.

Credit rating agencies have come under close scrutiny since the onset of the financial crisis. EU legislation has already been amended to give the newly created European Securities and Markets Authority regulatory authority over credit rating agencies.

More recently, though, attention has focused on the influence of credit rating agencies on sovereign borrowing. This follows their downgrading of the debt rating of Spain, Greece and Portugal at a time when the euro area is struggling to maintain market confidence. The European Parliament has called for special attention to be given to sovereign debt ratings and has suggested the creation of a European ratings foundation as a possible counterweight to the influence of the three largest US based credit rating agencies.

The aim of the inquiry is to investigate whether additional regulatory changes are needed to improve the relationship between credit rating agencies and sovereign debt. The inquiry will examine the origins of sovereign debt ratings and their implications for sovereign borrowing. It will assess whether an EU credit rating agency is a plausible option, or whether there are more desirable and practical solutions. The Committee will publish its report before the end of July 2011.

Particular questions raised to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues):

1) Credit rating agencies and sovereign debt

What role do credit rating agencies perform?

What is their purpose and role with regard to sovereign, as opposed to commercial, debt? How do CRAs determine their sovereign ratings, and who pays for these ratings? Is there an over-reliance on the judgement of CRAs?

What market-based indicators could be used to evaluate sovereign debt instead of ratings issued by CRAs?

Do financial markets overreact to a downgrading of sovereign debt by CRAs? Did CRAs fail to correctly rate certain EU countries in the run-up to the financial crisis? Have they continued to do so?

What role, if any, did CRAs play in exacerbating the euro area sovereign debt crisis?

Should the scope for private CRAs to rate sovereign debt be reduced or eliminated? If so, why, and how?

2) The regulatory framework for credit rating agencies

Could the EU regulatory framework for CRAs be developed to improve the quality and transparency of ratings of sovereign debt?

Should CRAs be required to give governments advance warning before publishing ratings of sovereign debt? What would be the pros and cons of such an approach?

Should a common EU-level principle of civil liability for credit rating agencies be introduced? What alternatives might be adopted to make CRAs accountable for their opinions?

What action might take place in the US in relation to CRAs and sovereign debt? What impact might US actions have on EU proposals in this area?

3) A need for European credit rating agencies

Does the credit rating market suffer from being dominated by three major firms? Should more competition be created in the field of credit ratings, and how might this be done? Would the existence of more competition contribute to a better quality of ratings and reduce volatility in the sovereign bond markets?

What are the potential benefits and downsides of creating a European Credit Rating Agency? Might there be any unintended consequences from its creation?

What might the structure of an EU-based credit rating agency be, and how would it be established?

How would the ratings offered by an EU based CRA differ from those provided by the US based CRAs in terms of content and market credibility?

4) Alternative proposals

Should the European Central Bank be charged with rating public debt and bonds instead of credit-ratings agencies?

Should the use of internal credit ratings, particularly by large financial institutions, be encouraged? If so, how?

We also would welcome your views on any other aspect of this topic. Written submissions need not address all questions

Interested parties are invited to submit a concise statement of written evidence to this inquiry by Friday 6 May 2011.

APPENDIX 4: GLOSSARY

ABI	Association of British Insurers
CRA	Credit rating agency
EACRA	European Association of Credit Rating Agencies
ECB	European Central Bank
ESMA	European Securities and Markets Authority
Fitch	Fitch Ratings
FSA	Financial Services Authority
ICFR	International Centre for Financial Regulation
IMA	Investment Management Association
IMF	International Monetary Fund
MEP	Member of the European Parliament
Moody's	Moody's Investors Service
OECD	Organisation for Economic Cooperation and Development
S&P	Standard and Poor's Ratings Services