# 5. Public Sector Credit Rating Agencies = More Stable Financial Architecture

By Peter Bofinger

The design of a more stable global financial architecture is currently the most important topic on the international agenda. But compared to the dimensions of the financial crisis, the solutions that have been put forward seem rather modest. While there is no doubt that more transparency as well as better designed and stronger capital buffers will help to make the global financial system more stable, it is far from clear whether such a piecemeal approach will help to prevent major crises in the future. The almost unlimited government support of banks in the current situation raises the stakes even higher and has increased the incentive problems facing bank depositors and lenders.

## Current Reform Proposals Are Not Radical Enough

The most radical reform that would be required to make the global financial system more stable is the establishment of effective international banking supervision instead of the extremely fragmented supervisory landscape we have at present. It is naïve to believe that national regulators will be able to regulate and supervise a highly integrated international financial system in an effective way. More coordination among national supervisors, especially in the form of supervisory colleges, and an early warning system under the auspices of the International Monetary Fund (IMF) are certainly helpful in this respect but they are an imperfect substitute for a global regulator.

While fundamental reform faces the almost insurmountably high hurdle of national interest, a radical solution is actually more realistic. When one tries to identify the main culprits of the current crisis, there is little doubt that the credit rating agencies have played a leading, if not the decisive role. Without their reckless ratings-structured products the excessive growth of these assets would not have been possible, and more generally the shift from a bank-based to a market-based financial system would have evolved in a much more gradual way. In the brave new world of market-based finance the rating agencies have played several important roles:

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- First, they advised banks to design portfolios of low quality assets such that a large share of seemingly high quality assets would be created.
- Second, they rated their own creations, which made it possible for banks, pension funds and insurance companies to invest in such assets. In this way the rating agencies played the role of “delegated monitor” that—thus far—has served the needs only of the banks.
- Third, as not only private investors but also bank supervisors all over the world

did not question the quality of the ratings, the agencies *de facto* served as privately-owned bank supervisors for the growing segment of asset-backed securities.

## The Moral Hazard Problem of Private Rating Agencies

It is now widely agreed that the conflicts of interest which arise out of the dual role of consulting (in the process of structuring) and rating (the products created in such a process) need to be addressed. But the role of rating agencies as delegated monitor and *de facto* private supervisor of the universe of market-based finance has so far not been questioned.

This is surprising since the performance of the agencies has been far from satisfactory. In the past three decades no financial crisis has been anticipated by these institutions. Famous examples include the Asian crisis in 1997 (Ferri et al. 1998), the breakdown of Enron in 2002 and of course the current crisis. In the case of Lehman Brothers, up until 12 September, 2008 the ratings of this investment bank were beyond reproach and had not been changed for months (Standard& Poor's: A, Moody's: A2, Fitch Ratings: A+).

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The dismal performance of rating agencies can be explained by their incentive structure. When the rating business began in 1909 with railway bonds, the agencies were paid by investors who needed information on the quality of the issuers (Partnoy 2006a). This changed in the second half of the 20th century when the rating agencies were paid by the issuers of securities. This result produced an incentive to be lax since more generous ratings increase the volume of business. The incentive problem is magnified by the fact that the agencies do not assume any responsibility for their ratings. The agencies regard themselves as journalists and their ratings as "opinions" protected by the First Amendment of the US Constitution (freedom of speech). In other words, while the profits of overly generous ratings accrue to the agencies, the costs must be borne by investors or by governments when they have to bail-out the issuers. This is the typical structure of a moral hazard problem: an agent incurs excessive risks since he is protected against losses by another institution.

It has been argued that effects of this asymmetric incentive structure are constrained by the negative effects of inadequate ratings on the reputation of the agencies (Covitz and Harrison 2003). But this argument overlooks the fact that due to the oligopolistic market structure there is no effective competition between the three major rating agencies. Given repeated failures in the rating process, market forces should have had the effect of driving at least one agency out of business. However, while many banks and other financial institutions have become insolvent or have had to be nationalized in the past 18 months, all three rating agencies have survived the storms of the financial crisis remarkably well. In other words, the market process has not been able to sanction the rating agencies for their overly positive assessment of highly dubious assets.

If one takes into account the important role attributed to external ratings in the regulations of Basel II, it seems very questionable that a more stable financial architecture can be achieved as long as rating agencies remain in private hands. While it will be possible to improve the performance by a better code of conduct (CRA Code of Conduct 2008 by the International Organization of Securities

Commissions[1]) and a public regulation of rating agencies, it seems almost impossible to overcome the fundamental problem of an asymmetric incentive structure of private rating agencies that operate in an oligopolistic environment without any liability for their ratings.

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## Hayek and the Rationale of Public Rating Agencies

The obvious alternative is a state-owned credit rating agency. Without a profit motive the incentives would no longer be biased. Of course, if ratings are given by a public institution the governments would be responsible for mistakes in the rating process. But as the current crisis shows, governments are already now obliged to bail-out banks that have relied on the ratings of private institutions. Ratings by public institutions would thus be consistent with the principle of competence and liability. The shift from private to public agencies could induce a relatively conservative rating culture but given the huge social costs of imprudent ratings by private agencies such a conservative bias is exactly the element of stability that is required for a more robust financial architecture.

The case for public credit rating agencies can also be made by referring to Friedrich A. Hayek's fundamental justification of the market mechanism. In his famous American Economic Review article, he writes:

"If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. We cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating all knowledge, issues its orders. We must solve it by some form of decentralization".[2]

Thus for Hayek, the rationale for the market and private agents rests fundamentally on their advantages in terms of gathering and processing decentralized pieces of information. But this justification does not apply to rating agencies. A global financial system with only three major agencies comes very close to Hayek's model of central planning:

"The statistics which such a central authority would have to use would have to be arrived at precisely by abstracting from minor differences between the things, by lumping together, as resources of one kind, items which differ as regards location, quality, and other particulars, in a way which may be very significant for the specific decision. It follows from this that central planning based on statistical information by its nature cannot take direct account of these circumstances of time and place".

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[1] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf

[2] Friedrich A. von Hayek, The Use of Knowledge in Society, *AER*, 1945

agencies, the global financial architecture would become more stable with public credit rating agencies.

## A European Initiative Would Be Sufficient

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As two US agencies (Standard & Poors and Moody's) play a predominant role, it is not very likely that the United States would support the case for public credit rating agencies. But in contrast to other reforms this approach does not require an international backing. It would be sufficient that the European Union member states decide to set up a public European credit agency. The establishment of another major agency would increase the global competition between rating agencies. In addition a public rating agency with a more conservative approach would have the effect that the competing private institutions have to adopt more rigorous standards. For the member countries of the EU such a public rating agency would have the additional advantage that its ratings could be used as a benchmark for bank supervisors for all banks within the EU. If the public agency does a better job than the private agencies, it would drive them out of business over time (Beetsma 2008). Thus it is not necessary to nationalize the existing agencies.

It is often said that every crisis brings a chance for things to be done better. This also applies to the financial market crisis which has now opened a window of opportunity to establish better regulations and institutions for the global financial system. While most of the proposals discussed so far are very useful, they lack the willingness to achieve fundamental reforms. As external ratings are of decisive importance for the universe of market-based finance, public rating agencies would overcome the very incentive problems of private agencies which should now be regarded as a main cause of the current turmoil. If this opportunity is not taken now, the international community will have to wait for the next crisis.

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[3] Fitch is owned by Fimalac a French company