EUROPEAN RISK ASSESSMENT AGENCY

AN ANSWER TO CREDIT RATING AGENCY

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Credit Rating Agencies

Credit Rating Agencies (CRAs) play an important role in current financial markets. They assess the credit risk of specific debt securities and the borrowing entities in the corporate bond market; they provide ratings on complex structured financial products such as asset-backed securities, mortgage-backed securities, and collateralized debt obligations (focus on the type of pool underlying the security and the proposed capital structure to rate structured financial products) and attribute ratings to sovereign borrowers (national governments, state governments, municipalities, and other sovereign-supported institutions, who are the largest borrowers in most financial markets), which reflects its ability to repay its debt.

Additionally, many Banks build their risk models based on the transition matrices published by CRAs (like JP Morgan's *CreditMetrics*). Transition matrices are the representation of the historical probability of migration from one rating to another, as well as the probability of default.

From/to	AAA	AA	A	BBB	BB	B	CCC/C	D	NR
AAA	87.03	9.03	0.54	0.05	0.08	0.03	0.05	0.00	3.19
AA	0.54	86.53	8.14	0.54	0.06	0.07	0.02	0.02	4.07
A	0.03	1.83	87.55	5.38	0.35	0.14	0.02	0.07	4.64
BBB	0.01	0.11	3.58	85.44	3.75	0.56	0.13	0.20	6.23
BB	0.01	0.03	0.14	5.16	76.62	6.96	0.66	0.76	9.64
B	0.00	0.03	0.10	0.21	5.40	74.12	4.37	3.88	11.89
CCC/C	0.00	0.00	0.14	0.22	0.65	13.26	43.85	26.38	15.49

Source: Standard & Poor's (1981-2014)

Therefore, ratings are used at three levels: Consumer (used by banks to determine the risk premium to be charged on loans and bonds); Corporate (companies planning to issue a security most of the times find a rating agency to rate their debt, or use another firm's as a proxy); Country (investors rely on the ratings given by the credit rating agencies to buy sovereign bonds).

The Problem

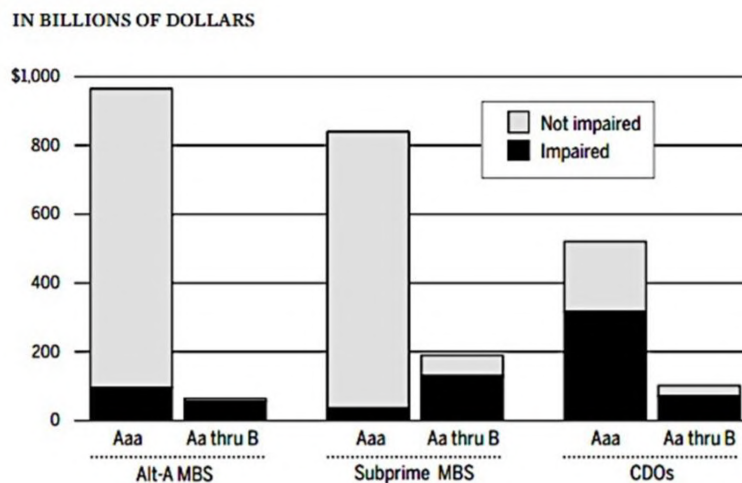
Credit Rating Agencies have been a central topic of discussion amongst economists and politicians, especially since the financial crisis of 2007/08. The oligopolistic CRA market is dominated by The Big Three (S&P, Moody's, and Fitch Group) which hold up to 93% market share, while DBRS holds roughly 2% and other CRAs hold less than 1% each.

Moreover, the ECB's use of sovereign debt ratings to decide on countries' eligibility for "unconventional" monetary policy programs (like Quantitative Easing) can be problematic, especially in future crises, where "conventional" monetary policy will be less effective (due to very low/negative interest rates):

1. Even though CRAs publish transition matrices and several other statistics on defaults, they do not say that ratings imply a specific probability of default. In fact, they argue the opposite:

"Credit ratings are opinions about credit risk. [...] Credit ratings can also speak to the credit quality of an individual debt issue, such as a corporate or municipal bond, and the relative likelihood that the issue may default. Credit ratings are not absolute measure of default probability." — Standard and Poor's internet page "Understanding Ratings", 02-12-2015

2. The three main CRAs claim to rate "through-the-cycle" and emphasize that ratings are just a relative ranking. They argue that they will not downgrade everybody just due to a recession. However, this happened during the financial crisis and subsequent Eurozone sovereign debt crisis, both with private and public securities.



Source: Moody's Investors Service (1993-2009)

3. The fact that CRAs are paid by issuers generates a huge conflict of interest. In the wake of the 2008 financial crisis, the US government sued S&P (in February 2013) for deliberately inflating ratings and understating the risk associated with mortgage securities and CDOs. In April 2013, S&P responded in court by saying that claims to have subjective ratings corrupted by conflicts of interest were "mere puffery".
4. CRAs have total discretion in their rating systems and are not required to make their rating methodology public (lack of transparency).
5. CRAs claim to try to reach a balance between ratings stability and accuracy. This leads them to revise ratings only between 1 and 2 years on average, which can result in a lagged view on the probability of default.

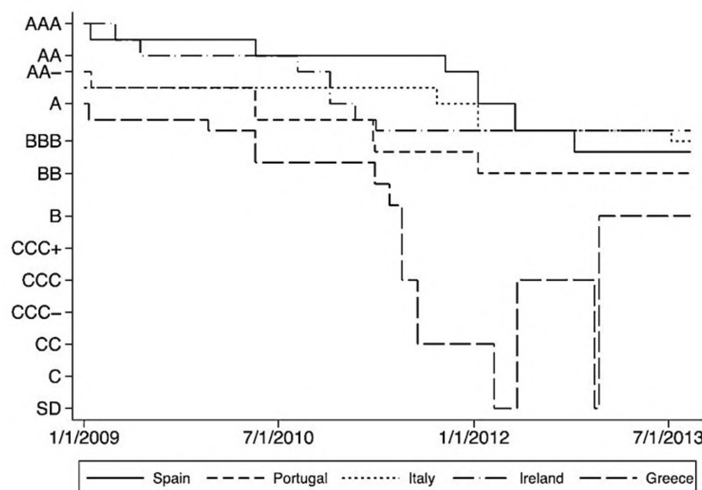
The Consequences

Before looking at what happened with Eurozone countries like Portugal, Greece, Ireland, Italy or Spain, one should analyze the possible effects of a downgrade. These can range from an increase in interest rates; decrease in liquidity of the bonds; sovereign debt feedback loops (since Basel II only investment grade bonds are considered as high-quality liquid assets, meaning that if banks hold national debt, their balance sheets will be impaired by a downgrade, which can lead to government intervention, weakening the whole economy and increasing the likelihood of another downgrade); ineligibility to be part of the

QE policy by the ECB (only for investment grade bonds) and overall more speculation due to higher risk aversion of investors towards its debt.

In the years prior to the 2008 financial crisis, the Big Three were considered to have been "overly-optimistic" with their ratings. Once the crisis hit, their ratings went into a very fast downward spiral. This has been considered by several economists to have contributed to a domino effect that further worsened the crisis (especially during the Eurozone sovereign debt crisis). Instead of being "acyclical", like they are advertised to be, ratings seem to be very procyclical: in times of prosperity, ratings remaining relatively high and stable; in times of recession, the ratings drop sharply.

Furthermore, it is normal for an economy to be weaker during a period of contraction, albeit one should differentiate between systematic and country-specific risk. Ratings of Eurozone countries pre-2008, did not properly reflect its weaknesses, especially relating to current and public accounts deficits. Moreover, these were country-specific risks, which should have been weighted properly in the appropriate time-frame. Yet, it seems that more importance is given to systematic risk: the risk that is common to all economies, in a globalized crisis like 2008, or in the Eurozone sovereign debt crisis of 2012. The CRAs should rate "through-the-cycle", and not only claim to do so: instead of being smoothed and (almost) uncorrelated with the state of the economy, the variance in ratings ends up being stochastic.



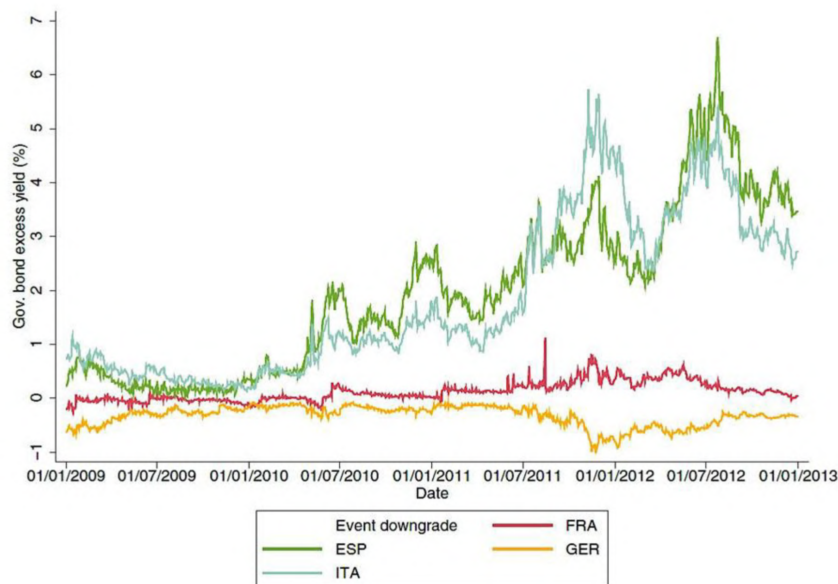
Source: Baum, Schäfer, Stephan "Credit rating agency downgrades and the Eurozone sovereign debt crises"

Subsequently, the question that ponders is why this happens, and what can we do to change the "system". The lack of competition and regulation in the CRA market may be the main issues. Despite having a huge impact on a country's economy via interest rates on sovereign debt, it is only "their opinion". This prevailing rhetoric has made any effective regulation, increased (relevant) competition, and accountability almost impossible. Moreover, it is very hard to impose restrictions on these firms, because, for all purposes, they are private firms. It is difficult to make private firms accountable for their mistakes, when they argue it is just their "relative view on credit worthiness", even if they produce huge externalities on the sovereign economies.

The underlying issue is that they are inherently seeking to maximize profits. Their business model is very prone to conflicts of interest, which can jeopardize the efficiency/quality of the ratings and may transform this system into a decision based on politics, rather than sound financial analysis. For example,

in April 2009, Standard and Poor's called for "new faces" in the Irish government, which was considered as tampering with in the democratic process. In late 2013, there was also controversy as S&P downgraded France's credit rating, without structural motives to back it. In February 2015, S&P agreed to pay a 1.5 billion dollar fine, without admitting wrongdoing. S&P was the only credit rating agency sued by the U.S. Justice Department, even though its competitors also issued top ratings for similar subprime-backed securities. Notice that S&P had downgraded the US's AAA debt rating to AA+ in August 2011, based on imprecise estimates, in what became known as the $2 Trillion Error.

The politization of the whole process can become a big macroeconomic issue, when sovereign debt is evaluated, as it influences the performance of that country's economy, its public policy, political stability and so on. Also note that intervening on only one rating firm may have no effect at all, as the oligopolistic demeanour of this market can incentivize perverse behaviour from all incumbents ("if S&P doesn't give the rating the issuer wants, he/she will simply go downtown to Moody's and get the rating they desire").



Source: Baum, Schäfer, Stephan "Credit rating agency downgrades and the Eurozone sovereign debt crises"

On average, one notch downgrade was associated with yield increase by 98 bps for Greece, 65 bps for Ireland and 33 bps for Portugal. The recent downgrade on Italy may cost up to 23 billion euro per year. The downgrade per se, produced around 98 basis points increase in yield, while the event outlook created 127 bps increase in yield. Sometimes a rating event from a country can even have impact on the other countries' interest rates. This was the case with the Greek downgrade, which affected yields in Ireland and Portugal (with smaller impact on Italy and Spain).

The US and the EU have enacted legislation to control the agencies' power. However, these were not very effective, and so, in 2010, the EU thought about creating a public financed credit rating agency. This attempt wasn't successful either, due to accusations of market manipulation, insufficient credibility, and the lack of financing. It is our opinion that creating a publicly-financed European CRA will continue to be almost unfeasible.

There are over one hundred national and regional rating agencies which could issue ratings if they are able to build up their credibility by meeting the conditions for being registered by European Securities and Markets Authority (ESMA). They could also use data from the European Central Bank and the International Monetary Fund to help with their analyses. In November 2013, credit ratings organizations from five countries (CPR of Portugal, CARE Rating of India, GCR of South Africa, MARC of Malaysia, and SR Rating of Brazil) joint ventured to launch ARC Ratings, a new global agency advertised as an alternative to the "Big Three". Until now, no CRA has been able to set itself as a relevant force in this market. This strong established American Oligopoly has continued to disincentivize transparency, lower prices, innovation and has continued to create significant entry barriers.

The Solution – European Risk Assessment Agency (ERAA)

As new challenges approach for the Eurozone, we encourage the creation of ERAA (European Risk Assessment Agency). Fully financed by the Eurozone (if possible the EU), ERAA would be a public independent institution with the purpose of measuring the risk of a country's public debt (initially, at least). Furthermore, it would be composed by several research groups (members of the national central banks) and by a council.

The research groups (with at least one member from the evaluated country) would be responsible for writing a risk report about a country's sovereign debt. The risk measures, assumptions and models should be as transparent as possible. That report should conclude on one out of five levels of risk: Green (risk free debt), Blue (low risk debt), Yellow (medium risk debt), Orange (high risk debt), or Red (very high-risk debt), for instance. For the report to be binding, it would have to be approved by the council. This council could be composed by the presidents Eurozone country's national Central Banks and its president (2-year periodic rotation among CBs' Presidents of the 5 biggest Eurozone economies) would not vote but could have veto power. Another possibility could be the approval of these reports by the EcoFin, to avoid creating another European council, and possible conflicts of interest.

In order for ERAA to be relevant, the ECB should promote a change to its criteria for QE, and subsequent asset-purchase programs. Currently, a Eurozone country is eligible for the QE if its public debt is in the investment grade area for at least one of the relevant rating agencies. The main feature of our idea is that the eligibility requirements for the Quantitative Easing by the ECB should also include the risk evaluation of ERAA: a Eurozone country should only be excluded from QE if its public debt is not in the investment grade area for all the relevant rating agencies and if its public debt's risk level is higher than yellow. This means ERAA would not be distorting the private market of Credit Ratings. Rather it would work more as an insurance policy.

The creation of a European Risk Assessment Agency is the glue that binds the present to the future sustainability, whilst providing a partial solution to asymmetric information in the credit rating of sovereign debt in financial markets. This would reduce the biasedness of the ratings' process by incentivizing the CRAs, which would still operate essentially in an oligopoly, to be more transparent and more accurate. Notice that this institution would also be incentivized to be as accurate as possible: "offering" ratings would impair its reputation and that of every NCB president.

We recognize that this "wheel" is almost impossible to break, and that there are no perfect solutions. Nevertheless, sometimes, the "least worst" solution is the only way to promote the well-being of economic agents: introducing a sort of public financed alternative to compensate for the current lack of competition, to mitigate the associated negative externalities and to avoid that the whole Eurozone economy is dependent on three large American private firms.

It is in times of growth that we should deal with these problems, mainly as new issues, like Brexit or the Trade War, threaten the economy of the Eurozone and European Union. This will become more relevant as the LIRE (low interest rate environment) limits the real effects of conventional Monetary Policy on the economy. The Eurozone and the EU should learn from the mistakes of the past, in order to provide a more robust answer to future downturns.

This institution could also complement the concept of pooling the sovereign debts of Eurozone member-states, the sovereign bond-backed securities (SBBS), to create a "bullet-proof" High-Quality-Liquid-Asset, by providing a risk assessment of its underlying assets.

ERAA should be also be accompanied by the promotion of a new revenue model of CRAs together with an improved legal framework. We recommend that there should be a return to the "investor-pays-model" in combination with a change in the compensation system within CRAs (adapt a results-oriented compensation system within CRAs, incentivizing them to be as accurate and objective as possible). The improved legal framework should promote more regulation and oversight as well as trying to hold the CRAs responsible for their ratings (as much as possible). The CRAs should disclose their underlying assumptions, they should be responsible for failed ratings (with big negative externalities) with an increase in Due Diligence, and potentially could implement rating-intervals system instead of punctual ratings, to avoid sharp discrete changes, that have been correlated with the discussed vicious cycle.

Finally, we will address about possible criticisms in the following table:

POSSIBLE ISSUES

| Publicly financed CRA idea failed in the past and does not seem do gather much support: ERAA is not a CRA per se. Rather, it is more like a complementary institution to the ECB and ESRB. Its core purpose would not be rating private firms (initially, at least); rather it would strive to promote symmetry of information/transparency in sovereign debt markets and to reduce conflicts of interest.

| Conflict of Interest with NCB presidents (vote on ECB council and ERAA council): The presidents of the National Central Banks should be as independent as possible, in all decisions. When the ECB council decides on matters of monetary policy, they can also be incentivized to vote in favour of a policy that is favourable to their country. We argue that, whilst there is some conflict of interest, it is better (or not so bad as) than having whole countries' economies on the hands of three private companies. Nonetheless, the council could be different, though we think this is the most appropriate design.

| Financial/Human costs of another European institution/actual necessity to give an answer to the CRAs: ERAA should leverage on the Economies of Scope due to the underlying nature of its concept. It should also endorse cooperation between the Member-States' Central Banks, whilst at the same time promoting the reduction of speculation that can arise from the excessively-procyclical ratings.

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