Reining in the Rating Agencies

Through the ongoing and mind-numbing complexity of the European sovereign debt crisis, the bureaucrats in Brussels can be relied upon to introduce some absurdity into their deliberations. The latest is a report in the FT that under certain circumstances the EU will suspend the ability of rating agencies to evaluate sovereign credits. Now it's true that markets are generally too reliant on credit ratings issued by S&P, Moody's and Fitch. The basic business model of charging the issuer for the rating is fraught with conflict, as catastrophically revealed during the sub-prime crisis. However, alternative models are hard to identify – increased competition among rating agencies would likely cause a "race to the bottom" in which issuers would flock to those with the most forgiving standards. And charging investors, the actual users of the ratings, is regarded by many as unworkable.

But the downgrade of U.S. debt that occurred in the Summer highlighted the absurdity of the rating agencies evaluating sovereign debt. Unlike a corporate issuer where a detailed financial analysis encompasses most of the necessary work, sovereign credit analysis incorporates a political judgment as well. The U.S. downgrade in the Summer illustrates the rating agencies straying beyond their expertise. U.S. creditworthiness is based to a large degree on a willingness to repay debt, and an opinion on which is as much political as it is financial. The rating agencies have no more insight on the politics than many other informed observers, and as such their opinions ought to be irrelevant except for the fact that so much bond investing is rules-based driven by the ratings that these agencies issue. Many bond investors are required to hold issues with minimum ratings from the three Nationally Recognized Statistical Rating Organizations (NRSROs), otherwise known as S&P, Moody's and Fitch. But really, since sovereign issuers have the ability to tax, their credit ratings are by nature not simply financial. The ratings frankly shouldn't carry any more weight than other sell-side research on bonds.

As sensible as it might seem to ditch the legal support for NRSRO-issued sovereign credit ratings, the EU bureaucrats in Brussels have revealed their own muddled thinking in the latest proposal. No doubt France's impending loss of its AAA rating, a possibility the French regard with horror but which financial markets have already moved past, is the catalyst. The FT reports that under proposed EU regulations ratings will be suspended *during times of financial stress.* So good ratings are fine, but bad ones are not. And presumably the EU's credit experts will anticipate trouble by suspending ratings prior to a downgrade, therefore providing an eloquent and informed signal to investors that perhaps those bonds are not quite as safe as previously thought.

In the U.S. we can be grateful that we don't subsidize such entertaining idiocy with our tax dollars. It must be more frustrating for those sitting in Europe.