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RATING AGENCIES: AN INFORMATION PRIVILEGE WHOSE TIME HAS PASSED

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Rating agencies: an information privilege whose time has passed

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EXECUTIVE SUMMARY

The European Union's response to the financial crisis as regards credit ratings and rating agencies should be grounded in a proper identification of the underlying problem. These agencies make an easy target for scapegoating, even if their responsibility is smaller than that of some other market participants. That said, **rating agencies have failed the marketplace** in the run-up to the crisis, as their risk assessment processes have been found wanting on a number of counts. However, it is **not clear that conflicts of interests have been the root cause** of this serious failure, even if such conflicts may have existed. Thus, legislation eliminating conflicts of interests (supposing such a thing were possible) would probably not address what really went wrong, and may in addition have harmful unintended consequences. This is a complex policy issue for which there exists **no simple, quick fix**.

Fair competition in financial risk assessment services

The real problem, running deeper than the possibility of conflicts of interests, is that **our system of financial risk assessment is broken**. Investors, regulators and other market participants now realise that the information basis on which they have been used to considering financial risk, consisting in large part of credit ratings, has been insufficient and, to a certain extent, distorting. What we need are whole **new forms of intermediation of the information about financial risk**. However, while the need for new types of financial risk assessment services is increasingly obvious, it is not yet clear what exactly they will be. Public policy should maximise the chances of such new services emerging quickly through **fair competition**

among risk assessment firms, rating agencies or otherwise, an environment where rating agencies will not necessarily prevail and in which they should not be given any unfair advantage in view of their recent failings. One crucial aspect is that **rating agencies should no longer be granted the information privilege** they currently enjoy compared with other market participants whose business is partly or mainly to assess financial risk.

Avoid unintended consequences

Beyond this crucial point and in view of existing proposals, the European Union should be mindful of the '*primum non nocere*' principle and make sure that its legislative initiatives do not make the situation worse than it currently is. This principally applies to three dimensions:

- The new legislation should not result in **decreased competition** on the market for credit ratings, entrenching of the current oligopoly and raising barriers to new entrants.
- The new legislation should not result in **reduced independence** of the rating agencies, through mechanisms that would allow political authorities to exert direct or indirect discretionary pressure on agencies to modify their ratings.
- The new legislation should not result in **fragmentation of the global and European financial space**, at the risk of making all economic actors poorer. The openness of the financial system is a global public good whose integrity is not guaranteed in the current environment, and which policymakers must strive to preserve.

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1 A BROKEN SYSTEM OF FINANCIAL RISK REPORTING

Rating agencies have played a central role in the way financial risk has been assessed by market participants in the recent past. However, a combination of flawed use of ratings and shortcomings in the ratings themselves has led to a situation in which our system of financial risk assessment is unsuited to the needs of the marketplace.

The central role of rating agencies

For corporate and state issuers, much information about financial risk is in the public domain, including for listed corporate issuers in the disclosure notes to audited financial statements. Public information helps market participants form opinions about financial risk. However, a number of factors have conspired to give credit ratings a central role in the formation of judgments about risk, including that:

- Rating agencies play a useful role in mutualising the effort to analyse information, a costly process that most participants, even those who have their own credit research teams, cannot afford individually;
- Rating agencies have a unique historical perspective, experience, and proprietary databases of past credit behaviour of a large number of issuers;
- Rating agencies have access to some non-public information, typically on business prospects and financial planning in the case of corporate ratings, and on underlying assets in the case of asset-backed securities;
- Rating agencies are granted reference status both by widespread market practice and by public regulation, including (but not only) by the Basel 2 framework for banking supervision.

The centrality of rating agencies to market participants' financial risk assessment helps explain both the high degree of concentration of the market for rating services, and the observed high level of profitability of the three leading agencies. Moody's, the only large rating agency to be a stand-alone listed company, achieved the highest profit margins of all the companies in the S&P500 index for five years running in the early 2000s². In part because market participants display an apparent preference for the simplicity of having to analyse only a limited number of ratings, the rating business has developed into a 'natural oligopoly': new entrants have tended either to be absorbed by one of the three most established firms, or to remain relatively

marginal or specialised players. The author is not aware of any evidence of anti-competitive behaviour by the leading rating agencies to prevent new entrants from penetrating their market.

Rating agencies have come under repeated criticism, either for their delay in modifying ratings in view of market developments, or for the abruptness of unexpected downgrades. A stream of academic studies suggests that ratings have little or no informational value added compared to market signals³, and some observers have suggested that market indicators could advantageously replace the agencies' rating. However, there seems to be a strong consensus among market participants that rating agencies, for all their failings, serve a useful purpose.

Misjudgments by investors and regulators

The current crisis has exposed a number of misjudgments and policy mistakes made by a variety of market participants as regards credit ratings, including flawed investment policies and the creation of perverse incentives.

'The rating business has developed into a natural oligopoly'

Until August 2007, many participants in capital markets operated on the implicit understanding that credit ratings could provide the basis for their assessment of financial risk. Many investors, especially in fixed-income securities, made investment decisions mainly, even in certain cases solely, on the basis of the credit rating of the corresponding instruments. Such investment behaviour was plainly misguided. The distribution of risk is not identical for all issuers or securities, and this should have an impact on investment strategies beyond the mere consideration of a probability of default.

Beyond investors, a variety of market participants, both public and private, have assigned ratings a key role. Especially prudential regulators have automatically linked certain capital calculations under the Basel 2 framework for banking supervision to the credit rating of the corresponding instruments. Prudential rules have restricted the investment options of regulated players, including financial firms or investment funds, on the basis of credit ratings. In the private sector, some investment vehicles have similarly been restricted by contract to invest only in certain instruments on the basis of ratings, and rating 'triggers' have been inserted into loan agreements, thus ensuring that rating changes would automatically bear economic consequences.

2. Sam Jones, 'How Moody's faltered', *Financial Times / FT Weekend*, 17 October 2008.

3. See Richard Levich, Giovanni Majnoni and Carmen Reinhart (eds.), *Ratings, Rating Agencies and the Global Financial System*, Kluwer, 2002.

With hindsight, it seems odd that such an important role has been assigned to what the rating agencies themselves generally present as mere opinions, provided by firms which do not bear any significant liability for their misjudgments (although the jurisprudence is still underdeveloped, and situations may vary from one jurisdiction to another on this count). An obvious comparison is the media, which also expresses opinions on the assessment of a wide range of risks, including financial ones, and is subject to the same freedom and liability regime as rating agencies. While the media plays an important role in financial markets, no one would consider advocating that regulations or contractual clauses, such as those mentioned above, be based on the content of newspapers' editorials.

Rating agencies have failed the marketplace

However, some failings revealed by the current crisis are attributable to the rating agencies themselves. Specifically, they have failed to assess correctly the risk associated with a wide range of structured products backed by real-estate assets, most notoriously subprime mortgages in the US. The downgrading of a number of such products, which started too late in July 2007⁴, was a key trigger of the beginning of the crisis when, as a consequence, 'investors lost confidence in the ratings of a wider range of structured assets'⁵.

Unlike with equity analysts at the time of the internet bubble, no clear evidence has surfaced at this stage of conduct by the rating agencies that could unambiguously be characterised as a material breach of existing laws or regulations. However, there is increasing evidence of the agencies having been overstretched during the securitisation boom of the mid-2000s. Probably the clearest evidence so far is the report published on 8 July 2008 by the US Securities and Exchange Commission (SEC). A typical statement quoted in this report from an email sent in February 2007 by a senior analytical manager at one of the leading rating agencies states: 'We do not have the resources to support what we are doing now'⁶. This is particularly damning as the subprime segment, in contrast to other segments of the US real-estate market, did not rely on long historical data series, with the consequence that the in-depth analysis of each transaction and of the broader economic context should have been given especially high priority. Indeed, when the subprime downturn materialised in 2007, it was more abrupt, and revealed a different pattern of correlations from earlier housing downturns.

'Public policy should aim to close the risk information gap'

The picture that emerges is one in which the rating agencies were ready to compromise the quality of their processes in order to grab or defend market share in a booming environment, with the volumes and complexity of securitisation sharply on the rise in the years to 2007. Diligence has been deficient both at a 'micro' level, with not enough in-depth analysis of the assets underlying specific securities and/or the related risks, and at the 'macro' level. On the latter point specifically, insufficient market research (or insufficient attention given to it) could be one of the reasons for the agencies' failure to anticipate the major downturn in the US housing market in time and to revise their risk assessments accordingly.

The agencies' desire to maintain their high profitability levels may have played a role in these failings, which could otherwise have been at least partly addressed by adequate recruitment.

Conflicts of interest in the rating agencies' relationships with their clients may have aggravated the situation. Structured products inherently present more scope for such conflicts than traditional corporate ratings, in part because of the relatively small number of securitisation arrangers, mainly leading investment banks, compared to the relatively large number of rated corporates, which means that rating agencies are not crucially dependent on any individual corporate client. However, available evidence suggests that agencies may have failed even in cases where such conflicts were absent or immaterial.

This underallocation of resources and lack of sufficient market analysis is most obvious in the rating of subprime securities and a range of other structured products, mainly in the US. In contrast, rating processes appear to have remained of high quality in many mature segments, including prime residential mortgage-backed securities and other asset-backed securities. However, with hindsight the failings in relation to subprime and other products have had at least an indirect effect on the reliability of other ratings as well, most obviously those of financial firms which were negatively impacted by subprime-related downgrades. AIG, Fannie Mae and Freddie Mac were given a high 'triple A' rating by the leading agencies until a fairly short period before their downfall.

It is difficult to assess how existing regulatory regimes

4. Gretchen Morgenson, 'Debt Watchdogs: Tamed or Caught Napping?', *The New York Times*, 7 December 2008.
5. Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience', 7 April 2008.
6. US Securities and Exchange Commission, 'Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies', July 2008.

have influenced the extent of the shortcomings in rating processes. Structured products are significantly more developed in the US than in Europe, in terms of both volume and complexity. It is therefore unsurprising that most problematic evidence comes from the US, which does not necessarily mean that rating practice in Europe has generally met higher standards.

One can also observe that the fact that ratings in the US have been subject to a formal regulatory regime since 1975, strengthened by the Credit Rating Agency Reform Act of 2006, while no comparable regulation yet exists in Europe, does not appear to have made a material difference. Admittedly, implementation of the Credit Rating Agency Reform Act was too recent at the time the crisis erupted for a full impact assessment of that legislation.

The current financial risk assessment system is insufficient

The failings of the leading rating agencies leave the marketplace in a quandary. While it is easy to see that ratings have gained too much importance and trust in the last few years, it is not easy at all to see what might now take their place. Market measures of some risks, such as those provided by the price of credit-default swaps, have developed significantly over the past decade. But they are inherently very volatile, subject to market manipulation, and not necessarily available for all rated instruments. Thus, in spite of their usefulness, they do not fulfil the marketplace's need for financial risk information and analysis.

Financial risk information is inherently multidimensional, difficult to standardise and hard to analyse. Financial statements and accounting have historically been developed chiefly to serve the information needs of shareholders, who are also accorded privileged status in the conceptual framework that currently underlies the setting of International Financial Reporting Standards (IFRS)⁷. While an ongoing discussion to amend this framework would place creditors alongside shareholders as primary constituents of IFRS standards-setting, it is likely that financial statements and their disclosure notes will remain an inadequate source of information for some aspects of financial risk assessment in the foreseeable future.

'A diversity of opinions will always serve the marketplace better'

In any case, current levels of risk disclosure can hardly be considered satisfactory. A study by the Securities Industry and Financial Markets Association (SIFMA) indicates that 'enhanced disclosure and standardisation of information' comes first among the concerns of polled market participants⁸.

Moreover, disclosure is not the only, or perhaps even the main, aspect of a discussion about the requirements of financial risk assessment. Analysing the available information can take considerable time and resources, which, as mentioned, is one of the reasons for credit rating agencies' historic success. The current realisation that credit ratings do not carry sufficient informational content to guide investment decisions, and that they are not as reliable as had been widely assumed before, creates a demand for new forms of financial risk assessment, a 'risk information gap' which is not currently being plugged. This gap is made larger by financial innovation and is especially acute for new, comparatively untested market segments for which no long historical data series exist, as was the case with the subprime housing market.

2 HOW TO FIX IT: FAVOUR THE EMERGENCE OF NEW FINANCIAL RISK ASSESSMENT SERVICES

In order to ensure the proper functioning of credit markets, and especially of markets for fixed-income securities, public policy should aim to close the 'risk information gap' identified in the previous section.

A comparable information gap was bridged exactly a century ago, in 1909, when the first credit ratings were published in New York. This was a period of tremendous regulatory upheaval (the US Federal Reserve system was created by legislation passed in 1913, following a major banking crisis in 1907), but the response came at the time through the entrepreneurial initiative of John Moody, a financial journalist by background, whose name one of the leading rating agencies still carries.

Today's challenge is similar. Decentralised innovation is more likely than regulatory initiatives to invent the new forms of information intermediation that are needed to overcome the shortcomings of credit ratings. In other words, we need a John Moody for the twenty-first century, and she is more likely to be a private entrepreneur than a

7. International Accounting Standards Board, Framework for the Preparation and Presentation of Financial Statements, 1989. Freely downloadable in European Commission, 'Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting', November 2003.

8. SIFMA/ESF/ASF/AusSF report, 'Restoring Confidence in the Securitisation Markets', December 2008.

public official. As economists David Smick and Adam Posen put it, 'no one suggests that a central institution would definitely tell one the worth of a stock, especially under changing circumstances. So why should that be true for a fixed-income security? [...] Our financial system is a highly adaptable organism forever evolving. Disenfranchise the ratings dinosaurs and the broader system will produce a myriad of small, more agile, more inventive private risk assessment investor services'⁹.

The same argument goes against the idea suggested by some of transforming the rating agencies into a public monopoly. While there should be no objection to state-controlled rating agencies competing for financial risk assessment services (in compliance with the EU competition policy, which does not discriminate against state-controlled entities), introducing a monopoly, public or otherwise, would be counterproductive. Ratings are opinions about risks, and a diversity of opinions will always serve the marketplace better than one single source. Some commentators have used an analogy with public agencies that vet the safety of foods or drugs¹⁰; but if such an analogy is to be pursued, it is about the regulation of financial products, which is a different matter from their credit rating.

Among new risk assessment business propositions that may emerge or expand in the next few years, some may focus on the risk of default, as do credit rating agencies, and others on other dimensions of risk; some may make their assessments public, others may reserve them for their clients or, in the case of buy-side credit research, for proprietary investment purposes; some may be paid by investors, others by issuers, or by other market participants.

Rather than trying to impose a single model for the assessment of intrinsically multidimensional financial risk, public policy should mandate and enforce an adequate level and quality of disclosure, which is something only public authorities can do. Moreover, public policy should be designed to ensure that the rating agencies' current dominant position in the market for financial risk assessment does not prevent new and better risk assessment service providers from emerging through fair competition.

In practical terms, this means at least two things: fair competition among risk assessment methods; and equal

access to information. The first requirement would lead to the elimination of specific references to credit ratings in public regulations. The second requirement would lead to the removal of rating agencies' current information privilege, which has ceased to be justified by the quality of their service to the marketplace.

Fair competition among risk assessment methods

The specific reference by prudential rules and other regulations to credit ratings, mentioned in the previous section, started as far back as the 1930s in the US¹¹. But it has been much reinforced by more recent developments, including the extensive role assigned to ratings in the Basel 2 framework for banking supervision. The rating agencies themselves cannot be faulted for such developments, which they even tried to forestall in some instances¹². But, as expressed in vivid terms by recognised legal scholar Frank Partnoy, the result has largely been to shift them 'from providing information to selling "regulatory licences", keys that unlock financial markets'¹³. Other public rules that make specific reference to credit ratings apply to some investment funds, or to the types of collateral that central banks may accept in their liquidity operations.

The crisis has made obvious the perverse effects of such regulatory arrangements. To correct them, regulations should no longer refer specifically to credit ratings, but more broadly to appropriate risk assessments. In certain cases, these could be based on available ratings published by rating agencies, but the automaticity should be removed. The gradual elimination of the explicit reference to credit ratings has already started as a consequence of the crisis, especially in the US by the SEC, whose chairman has publicly recognised that '[the SEC's] own rules may be contributing to an uncritical reliance on rating agencies as a substitute for independent evaluation'¹⁴, an expression which is itself directly borrowed from the Financial Stability Forum (FSF)'s report of 7 April 2008. Other regulators should do likewise, especially (but not only) in the context of future revisions of the Basel 2 framework, as has been advocated by, among others, an eminent group of financial economists¹⁵.

Because credit ratings are useful to issuers independently of their regulatory impact, they would continue to be available throughout and beyond the transition to a regulatory

9. David Smick and Adam Posen, 'Disenfranchise The Ratings Agencies', *The International Economy*, Fall 2008.

10. Heiner Flassbeck, 'They should be taken over by a public regulatory agency', *The International Economy*, Fall 2008.

11. Richard Sylla, 'A Historical Primer on the Business of Credit Ratings', in Levich, Majnoni & Reinhart, *Op. Cit.* [see footnote 2].

12. See Daniel Tarullo, *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, 2008, p. 98

13. Frank Partnoy, 'Do away with rating-based rules', *Financial Times*, 8 July 2008.

14. Kate Plourd, 'SEC: Credit Ratings Are a Crutch', *CFD.com*, 26 June 2008.

15. Financial Economists Roundtable, 'Statement on Reforming the Role of the Statistical Rating Organizations in the Securitization Process', 1 December 2008; downloadable from: <http://fic.wharton.upenn.edu/fic/Policy%20page/FER12%201%2008rev.pdf>.

regime that would not itself make explicit reference to them. Thus, the suggested regulatory changes would not adversely impact market developments.

As also called for by the FSF, a parallel effort should be undertaken by private-sector market participants. For example, the European asset management industry recently announced steps to diminish their reliance on credit ratings¹⁶.

Ending the information privilege: equal access to information

'Regulations should no longer refer specifically to credit ratings'

For alternative forms of financial risk assessment services to emerge, a level playing field must imperatively be ensured in terms of access to information. Otherwise market participants will continue to assign priority status to credit ratings, if these are assumed to rely on more complete information than other sources. For ratings of corporate and financial issuers, this equal access is not guaranteed under present regulatory arrangements, which confer a *de facto* information privilege on rating agencies. Rating agencies are specifically exempt from some of the provisions of Regulation Fair Disclosure (Reg FD) in the US and of the Market Abuse Directive (MAD) and its implementing regulations in the EU, enabling them to access privileged information to an extent other market participants cannot (with the exception of the financial press). When Reg FD was adopted by the SEC in 2000, and the MAD by the EU in 2003, the concern was mainly insider trading by analysts or the financial firms which employ them. In the case of the risk assessment industry, the problem is not insider trading *per se*, but the undue competitive advantage that rating agencies enjoy through their access to non-public information¹⁷.

It has sometimes been argued that the extent of non-public information on which the rating agencies are reliant for corporate ratings is limited and does not significantly distort competition for risk assessment services. If so, the removal of the agencies' information privilege would not have any adverse impact on ratings quality. However, the agencies themselves have occasionally recognised that such information is important to them. For example, in a recent document that discusses the current business model of rating agencies, Standard & Poor's has noted that 'rating agencies using the subscription model [in which

users of ratings, rather than issuers, pay for the rating service] may have more limited access to issuers, who have no obligation to inform those agencies of material changes in their businesses. This type of information can be extremely helpful when providing forward looking ratings'¹⁸.

The rating agencies' information privilege may have been justified in the past by the perceived collective value of the services they delivered to the entire marketplace. In view of their recent failings, however, this privilege has become indefensible and should be taken away. Specifically, new regulations should ensure that any material information provided by issuers to the rating agencies should be made available to the entire marketplace through public disclosure. This could be done by removing the exemptions granted to the rating agencies in Reg FD and the MAD.

As issuers would be unwilling to suffer less favourable ratings based on limited information, they would have a strong incentive publicly to disclose key information which they earlier reserved to the rating agencies, to the benefit of the entire marketplace. Moreover, the spread of information technology makes broad disclosure much easier technically than was the case in the past. Thus, the removal of the agencies' information privilege is unlikely to lead to a decrease in the quality of ratings due to missing information, either on a temporary or a permanent basis.

Such a change is most obvious in the case of listed corporate issuers, which already disclose significant financial information. It could also be envisaged for unlisted corporate issuers, perhaps at a later stage. From this standpoint, the rules currently proposed by the SEC, which would force rating agencies to share such information with other rating agencies requesting it, may not go far enough¹⁹. In structured products as well, public disclosure should be vastly improved and harmonised at international level; some progress on this latter aspect may result from ongoing industry initiatives.

New forms of competition in credit ratings and financial risk assessment are already emerging. A number of specialised risk consultancies have prospered in the last few years, even though the current difficulties of hedge funds and of the asset management industry may make their economic environment more challenging in the near future. Coface, a

16. European Federation of Asset Management Associations (EFAMA), European Securitisation Forum (ESF), UK Investment Management Association (IMA), 'Asset Management Industry Guidelines to Address Over-Reliance Upon Ratings', 11 December 2008.
17. See François Meunier, 'Faut-il que les agences de notation soient « initiées » ?', *Risques/Les cahiers de l'assurance* No.61, March 2005.
18. Standard & Poor's, 'Guide to Credit Rating Essentials', 2008 [available on www.AboutCreditRatings.com].
19. Fact Sheet – Open Meeting of the U.S. Securities and Exchange Commission', 3 December 2008, on www.sec.gov.

France-based credit insurer, has announced the launch of a new rating practice, based on quantitative statistical analysis²⁰. At the other end of the methodological spectrum, Kroll, the business intelligence services group, is eyeing the creation of a rating service focusing on complicated financial products²¹. But not all such risk assessment providers need be rating agencies in the regulatory sense – with Nationally Recognised Statistical Rating Organisation (NRSRO) status in the US, or the equivalent future EU regime – as some of them may focus on other dimensions of risk, such as stress-testing in extreme scenarios, or assessment of the quality of issuers' risk management. New entrants are unlikely to realise their full potential as long as they are hampered by regulatory barriers or distortions. Conversely, a multiplicity of new models and methods for risk assessment could significantly contribute to financial stability.

3 THE CURRENT DRAFT REGULATION: AVOID UNINTENDED CONSEQUENCES

The thrust of the proposals presented above – removing references to ratings in public regulations, and ensuring that all providers of financial risk assessment services have equal access to information – does not put emphasis on regulating the rating agencies. Nor is such regulation even necessary from that perspective. The regulatory framework that has existed since 1975 in the US, reinforced by the Credit Rating Agency Reform Act of 2006, has not prevented the agencies' most visible failings so far from occurring there rather than in 'unregulated' Europe. As Annette Nazareth, then a (Democratic) Commissioner of the SEC noted of some observers in 2007, 'They wish government edict would make the credit rating agencies smarter and faster. The Credit Rating Agency Reform Act does not address that nor should it'²².

A new European framework to regulate rating agencies can bring welcome improvements. This may include higher requirements for internal documentation of ratings and for disclosure of past ratings' performance over time, as well as stronger limitations on consulting or quasi-consulting activities which may create conflicts of interest with the core ratings business. In fact, many such benefits are already provided by the regulation of rating agencies by the SEC, which has a de facto extraterritorial effect and is likely to be significantly reinforced in the near future.

However, regulating rating agencies in the EU also responds to a perceived political necessity. The trick here will be to

avoid unintended consequences while responding to this political pressure. Three main areas of concern are identified here and dealt with in summary fashion, as these topics have already been the matter of many contributions to the European policy debate, especially with regard to the European Commission's proposal for a regulation on credit rating agencies published on 12 November 2008.

Competition concerns

Regulation tends to impose one single model of organisation and activity modeled on existing examples, and thus may restrict the scope for new entrants on the risk assessment market by limiting the possibility of building a competitive edge through innovative and differentiating features. Moreover, regulation may introduce significant compliance costs, which favours large established players over new and smaller ones. Finally, a vast empirical literature tends to suggest that, in regulated industries, incumbent players tend partly to capture the regulator to their own advantage and to the detriment of potential new entrants, and there is no reason to believe that rating agencies would be any different.

Independence concerns

Regulation would empower national authorities to impose sanctions or otherwise exert coercive powers on the rating agencies, in some scenarios with a significant degree of discretionary power. Simultaneously, the same national authorities issue debt which is rated, and so do national agencies, local authorities, and state-controlled enterprises. It is not impossible to imagine situations in which the newly created regulatory power would be leveraged by national governments in order to exert pressure on ratings agencies to obtain more favorable ratings for such entities or for otherwise favoured 'national champions' in the private sector. Thus, regulation could play against, not in favour of, the quality of credit ratings.

This potentially harmful effect is larger if governments are granted more discretion when applying sanctions, and smaller if sanctions are triggered by objective factors (such as failure to disclose a defined set of data) on which governments have little margin for arbitrary application. Also, it would be much reduced if the power to apply sanctions were given to an EU-level regulatory body rather than to national ones, as the potential for conflicts of interest would be significantly reduced.

20. Jérôme Cazes (Coface): « Le projet de règlement proposé par Bruxelles ne résout pas les problèmes liés à la crise », *Les Echos*, 8 December 2008.

21. Brooke Masters, 'Kroll on the trail of a new conquest', *Financial Times*, 15 December 2008.

22. Sarah Johnson, 'How Will the SEC Rate the Rating Agencies?', *CF0.com*, 13 September 2007.

International fragmentation concerns

Given the global nature of the rating agencies' activities, and the obvious need for international consistency of ratings, there is a significant risk to fragmenting the regulation of rating agencies. From this perspective, a single regulator at European level would have been a more appropriate response than the rather clumsy, and potentially unstable, current proposal of 'colleges' led by a 'facilitator'. In practice, and given the concentration of the leading agencies' European activities in London, it is likely that the 'facilitator' will be the UK Financial Services Authority in most cases, which will raise issues of political legitimacy in continental Europe. This echoes the problematic nature of the 'colleges' concept more generally²³.

The risk of transatlantic fragmentation as a result of the new regulation has been widely commented upon. The

language of the European Council in December, mentioning 'the obligation for financial institutions to only use, for regulatory purposes, credit ratings which are issued by credit rating agencies registered in the [European] Community, since it appears the most appropriate solution to ensure a proper surveillance of these credit rating agencies'²⁴, raises significant concerns.

After having rightly lambasted the US Sarbanes-Oxley Act of 2002 for its extraterritorial effects, Europeans, who like to pride themselves on their multilateralist ethos, may now adopt legislation which is even more unilateralist. This is happening at a moment when international financial integration appears more at risk than for at least a generation, with potentially serious consequences for all economies. At a time of unprecedented need and arguably unprecedented opportunity for transatlantic and global financial regulatory initiatives, this would be an ironic development indeed.

23. See Nicolas Véron, 'Les collèges de superviseurs financiers, vraie ou fausse solution?', *La Tribune*, 26 November 2008; English translation available on www.bruegel.org.

24. Council of the European Union, 'Proposal for a Regulation of the European Parliament and of the Council on credit rating agencies – Progress report', Interinstitutional File 2008/0217 (COD), 16 December 2008.