Europe in wonderland

European politicians are still blaming rating agencies for the continent's debt crisis – obscuring some of the real problems posed by ratings, argues ***David Rowe***

It is a hard time to be a credit rating agency. After being rightly excoriated for the disastrous shortcomings of their analysis in rating structured sub-prime mortgage securities, they are now being pilloried for their understandable caution about falling behind the curve in the European sovereign debt crisis.

I have previously noted with approval Roger Bootle's comment that risk managers would do well to read less mathematics and more history and literature. I suspect, however, that he was not thinking of literature as far removed from our daily fare as *Alice in Wonderland*. Nevertheless, I was reminded of the below quotation while reading reports of José Manuel Barroso's tirade against the rating agencies on July 6, following the latest downgrades for Portugal, Ireland and Greece.

"When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean – neither more nor less."
"The question is," said Alice, "whether you can make words mean so many different things."
"The question is," said Humpty Dumpty, "which is to be master – that's all."[1]

A more ominous literary precedent is George Orwell's *1984*, in which Big Brother proclaims that war is peace, freedom is slavery and ignorance is strength. Now, with equally brazen self-assurance, the powers-that-be would have us believe demanding private sector participation in resolving Greece's problems does not constitute a default on sovereign obligations. Unless we are to corrupt language beyond recognition, such an interpretation cannot stand.

Barroso issued a thinly veiled threat to make rating agencies civilly liable for their decisions. Presumably this means imposing fines and other penalties if ratings prove inaccurate after the fact. In an additional Orwellian twist, he combined this threat with the observation that agencies are "not infallible" and that they failed to anticipate the crisis of 2008 properly. Presumably, we are to conclude from this that infallibility is required to avoid breaking the law.

Barroso also fell into the trap I addressed last month, when he implied that measures to improve the methodology and transparency of sovereign ratings and reduce conflicts of interest could resolve the problem (*Risk* July 2011, page 60, www.risk.net/2080207).

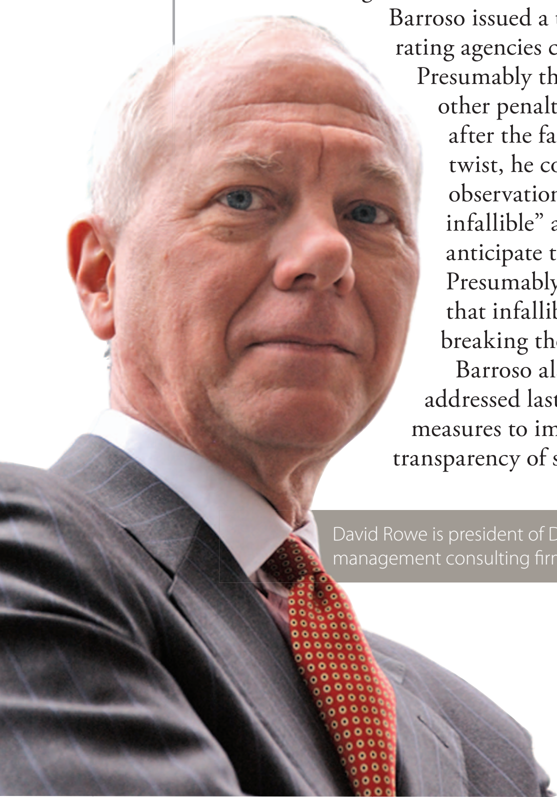
Of course, many attacks on the agencies are really a smokescreen for the real political agenda, which is to suppress the ability of independent voices to speak truth to power. The view seems to be that if only these pesky agencies were subject to the benevolent oversight of European authorities, it would be possible to paper over the fundamental flaws of a system of monetary union without fiscal union.

But it is hard to be wrong on every single count. Barroso argued, for example, that financial institutions should be less reliant on agency ratings, and I certainly agree with this. Nevertheless, Barroso must realise that one of the biggest contributors to this reliance is the inclusion of ratings in the Basel II capital framework. Responsibility for this lies primarily with banking regulators. While the framework was being drafted, the agencies were critics, questioning whether it would complicate their job.

Leaving aside the question of blame, however, it is genuinely important to tackle the self-referencing dynamic created by the inclusion of ratings in the regulatory capital system. Even where methods and integrity are wholly sound, official agency ratings are not simply external insights into an objective reality. As we have seen repeatedly, such ratings are part of the market dynamics surrounding the securities they evaluate. It is this feedback that so complicates the entire situation and is at the heart of Barroso's outburst.

In a related argument, Barroso calls for the introduction of greater competition in ratings – again, a desirable goal. In the same breath, however, he calls for the creation of a European rating agency. If such an agency emerged spontaneously this would be fine. Unfortunately, it is likely to be bureaucrats and politicians that shepherd a European rating agency into existence. Few would take the assessments of such an organisation seriously.

There is a more radical and more immediate way to foster competition in credit ratings. This is to abolish the entire concept of Nationally Recognized Statistical Rating Organizations – the registration system under which the big US agencies currently operate. Removing this certification role from the government would allow the emergence of specialised competitors, using a variety of techniques and covering differing securities and sectors. The market would be left to evaluate their effectiveness. Only when governments realise that the power wielded by officially recognised rating agencies is largely created by the governments themselves will they make any real progress in reducing the impact of self-referencing feedback effects. ■



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[1] *Lewis Carroll,* Through the Looking Glass and What Alice Found There *(popularly known as* Alice in Wonderland*)*