

**Comments on CESR's Consultation Paper:**  
*CESR's technical advice to the European Commission on possible measures  
concerning credit rating agencies*  
*November 2004*

**by Giovanni Ferri (\*)**

**(\*) Giovanni Ferri is Professor of Economics at the University of Bari**

Department of Economics  
Università degli Studi di Bari  
Via Camillo Rosalba, 53  
70124 Bari, Italy  
[g.ferri@dse.uniba.it](mailto:g.ferri@dse.uniba.it)

I read CESR's Consultation paper with great interest. In my opinion, it is a comprehensive and thorough review of the issues under study. It does so by taking the required regulatory approach. However, having spent a few years reading (and doing) economic research on Credit Rating Agencies (CRAs), I noticed that the paper lacks substantive reference to the analytical studies that have been published on these issues. In addition, although considering the situation in both the EU and the US, the Consultation paper disregards the experience of Japan, the only developed country where the three Global CRAs (GCRAs; Moody's, S&P, and Fitch) face some competition from established national CRAs (NCRAs; Japan Credit Rating Agency, and R&I). In these few pages I will try to offer a contribution in these two respects.

Though they originated in the US, GCRAs have come to play a key role in the functioning of international financial markets worldwide. Their ratings are now the main worry of sovereigns, municipal authorities, banks, and corporations around the world, as any downgrading would dent their capitalization and increase their interest burdens. GCRAs' ratings have even been adopted as a cornerstone in financial regulation.

Yet, the reputation of GCRAs has somewhat deteriorated in recent years. On the one hand, even in the US, where they traditionally maintained a good track record in terms of assessing the risk of the default probability of bond issuers, GCRAs failed to forewarn investors of major upcoming bankruptcies at large, well-known, listed companies (e.g. Enron, Worldcom, etc...). These failures called the public's attention to GCRAs, and the Sarbanes-Oxley Act mandated the SEC to review the appropriateness of rating industry regulations. On the other hand, the GCRAs' track record has also been poor in emerging countries. A well-known example is the East Asian financial crisis, where GCRAs' ratings lagged behind the markets. Awarding East Asian countries relatively high investment scores until a few months before the crisis, GCRAs suddenly downgraded their ratings to junk levels in countries like Korea and Thailand, countries which then promptly resumed their long-term impressive growth.

The main allegations of the literature criticizing GCRAs hinge on six points:

- (i) they tend to act too late (e.g. IMF, 1999; BCBS, 1999; Bhatia, 2002; Reinhart, 2002; Sy, 2004);
- (ii) but, once they act, they are too heavy-handed, thus swinging ratings procyclically (e.g. Block & Vaaler, 2004; Ferri, Liu & Stiglitz, 1999; Kaminsky & Schmukler, 2002; Kräussl, 2003; Monfort & Mulder, 2000; Mulder & Perrelli, 2001; Reisen & von Maltzan, 1999; Zhang, 2003);
- (iii) especially in developing countries, private ratings appear excessively linked to sovereign ratings (e.g. Ferri, Liu & Majnoni, 2001; Nickell, Perraudin & Varotto, 2000);
- (iv) the information content provided by their ratings seems better in more than in less developed financial markets (e.g. Ferri & Liu, 2003);

(v) the highly concentrated market structure of the GCRA industry in the US<sup>1</sup> brings up several issues, regarding possible rent extraction vis-à-vis rated entities (a distributional issue), potential underinvestment in the collection and processing of information on rated entities (an efficiency issue; e.g. Ferri, 2004; Ferri & Liu, 2004), and possible cut-throat behavior to conquer foreign markets (e.g. penalizing unsolicited ratings; e.g. Poon, 2003);

(vi) GCRAs may face conflicts of interest vis-à-vis debt issuers arising from three features of their business, namely: a) that GCRAs' fees are paid for by the debt issuers and increase with the size of the debt issued (so, it is feared that large issuers might exert some influence on the agencies; e.g. Burnie & Langsam, 2004); b) that the presence of undisclosed triggers relating to NRSRO (nationally recognized statistical rating organization) ratings may induce the rating agency to be unduly reluctant to downgrade issuers below investment grade (e.g. Johnson, 2003);<sup>2</sup> and c) that GCRAs, concurrently to issuing ratings to bond issuers, increasingly offer consulting to them.

After recapitulating the available evidence, we can conclude that while some of the allegations may be excessive, others appear fairly grounded. Yet, the ratings are an essential lubricant for financial market development, as they attenuate information asymmetries that investors undergo vis-à-vis issuers (Kliger & Sarig, 2000; Hull, Predescu & White, 2004; Dichev & Piotroski, 2001). Thus, even though more research is needed, authorities need to consider ways to improve GCRAs' working.

Several policy suggestions have surfaced, especially in the heated debate following the mega-corporate scandals. On the one side, we can distinguish the extreme view calling for the abolition of the NRSRO status, and a full liberalization of the credit

---

<sup>1</sup> The GCRA industry in the U.S. was largely derived from a regulatory franchise: for almost 30 years no significant new entry was allowed by the SEC in the list of Nationally Recognized Statistical Rating Organizations (NRSRO).

<sup>2</sup> If these ratings plunge below investment grade this causes adverse consequences, such as the shortening of debt repayment schedules.

rating business (e.g. Partnoy, 1999; White, 2001). On the other side, more balanced views recognize that, in spite of their recent failures, GCRAs perform a good job on average. These views, which advocate the stiffening of constraints on the GCRAs (which are activated by potential competition and the specter of increased regulatory scrutiny), thus recommend that the SEC permit provisional, location-specific, and industry-specific NRSRO designations (e.g. Hill, 2004). These efforts notwithstanding, with size and age conferring significant advantages, it's not easy for a new rating agency to be established or gain a significant presence in the market. Thus, recognizing that the market may still remain quite concentrated, it is suggested that regulatory reform should also encourage GCRAs to be more responsive to the needs of market participants, for example by raising their accountability through the creation of a public forum in which market participants could comment on GCRAs' performance. Also, periodic certification of GCRAs, verifying that they are operating in accordance with set procedures, might guard against conflicts of interest.

Furthermore, the above scenario describing the alleged weaknesses of the GCRAs raises a vital policy question for various countries/regions of the world wishing to accelerate their financial market development. Can these countries entrust their financial markets exclusively to the GCRAs? Or, rather, should they promote well-functioning National CRAs (NCRAs)?

The answer is not obvious. European and East Asian experiences differ in this respect. While in Europe short-lived national credit rating agencies were eventually acquired by the GCRAs, many Asian countries still have their own national credit rating agencies, even if no truly regional agency exists yet. On the one hand, NCRAs might be less independent (with their judgment subject to domestic influences) and the GCRAs could provide freer and more valuable guidance to markets. On the other hand, though, NCRAs could have a relative advantage in understanding local business practice and have a higher commitment to invest more in the rating of local

entities. Over all, it seems that a division of labor could be beneficial, with GCRA's specializing in multinationals/highly internationalized domestic issuers and NCRA's focusing on smaller-sized/less-internationalized local issuers. Perhaps, most interesting is the case of Japan, where two established NCRA's operate significantly alongside the GCRA's. It has been found that, particularly in the Samurai market, the Japanese NCRA's give a contribution, as shown by the fact that their ratings are highly correlated with market-determined credit spreads (BCBS, 2000; Packer & Reynolds, 1997; Packer, 2000), and possibly bestow a productive specialization as suggested above.

Having achieved its Monetary Union, the EU is in a good position to develop its financial markets. Maybe such goal could be pursued more effectively if the EU were to promote also some European NCRA's to operate alongside the GCRA's. Once more, this could prove complementary to the activity of the GCRA's and help provide the financial infrastructure of the rating on a cost-effective basis to the multitude of European SMEs, which may currently be discouraged from seeking a rating by the cost structure and/or by the perception that they do not represent a key business for the GCRA's.

## References

- Bhatia (2002) Sovereign Credit Rating Methodology: An Evaluation, IMF WP 170.
- BCBS – Basel Committee on Banking Supervision (1999) Supervisory Lessons To Be Drawn From The Asian Crisis, Basel Committee on Banking Supervision WP 2, June.
- BCBS – Basel Committee on Banking Supervision (2000) Credit Ratings And Complementary Sources of Credit Quality Information, Basel Committee on Banking Supervision WP 3, August.
- Block & Vaaler (2004) The price of democracy: sovereign risk ratings, bond spreads and political business cycles in developing countries, *Journal of International Money and Finance*.
- Burnie & Langsam (2004), How SOX affects investing through credit rating agencies, *Journal of Corporate Accounting and Finance*.
- Dichev & Piotroski (2001) The long-run stock returns following bond ratings changes, *Journal of Finance*.
- Ederington, Yawitz & Roberts (1987) The Informational Content of Bond Ratings”, *Journal of Financial Research*.
- Ferri (2004) More Analysts, Better Ratings: Do Rating Agencies Invest Enough in Less Developed Countries?, *Journal of Applied Economics*.
- Ferri & Liu (2004) Assessing the Effort of Rating Agencies in Emerging Economies: Some Empirical Evidence, *European Journal of Finance*.
- Ferri & Liu (2003) How Do Global Credit Rating Agencies Rate Firms from Developing Countries?, *Asian Economic Papers*, December.
- Ferri, Liu & Majnoni (2001) The Role of Rating Agency Assessments in Less Developed Countries: Impact of The Proposed Basel Guidelines, *Journal of Banking and Finance*, 25, 115-48.
- Ferri, Liu & Stiglitz (1999) The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis, *Economic Notes*, 28, 335-56.
- Hill (2004) Regulating the Rating Agencies, *Washington University Law Quarterly*.
- Hull, Predescu & White (2004) The relationship between credit default swap spreads, bond yields, and credit rating announcements, *JBF*.
- IMF (1999) *Capital Market Developments*, IMF, Washington DC.
- JCIF (1999, 2000, 2001) Characteristics & Appraisal of Major Rating Companies.
- Johnson (2003) An examination of rating agencies’ actions around the investment-grade boundary, FRB Kansas City RWP 03-01.

- Kaminsky & Schmukler (2002) Emerging Market Instability: Do Sovereign Ratings Affect Country Risk and Stock Returns?, *The World Bank Economic Review*.
- Kliger & Sarig (2000) The Information Value of Bond Ratings, *Journal of Finance*
- Kräussl (2003) Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises?, Center for Financial Studies (Goethe-Universität Frankfurt am Main), WP 18.
- Monfort & Mulder (2000) The Impact of Using Sovereign Ratings by Credit Rating Agencies on the Capital Requirements for Banks: a Study of Emerging Market Economies, IMF WP/69.
- Mulder & Perrelli (2001) Foreign Currency Credit Ratings for Emerging Market Economies; IMF: WP 191.
- Nickell, Perraudin & Varotto (2000) Stability of rating transitions, *JBF*.
- Packer (2000) Credit Ratings and the Japanese Corporate Bond Market, IMES DP E-9.
- Packer & Reynolds (1997) The Samurai Bond Market, *Current Issues in Economics & Finance*, FRBNY, June.
- Partnoy (1999) The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, *Washington University Law Quarterly*.
- Poon (2003) Are unsolicited credit ratings biased downward?, *JBF*.
- Reinhart (2002) Default, Currency Crises and Sovereign Credit Ratings, NBER WP 8738.
- Reisen & von Maltzan (1999) Boom and Bust and Sovereign Ratings, *International Finance*.
- Sy (2004) Rating the rating agencies: Anticipating currency crises or debt crises?, *JBF*.
- White (2001) The Credit Rating Industry: An Industrial Organization Analysis, NYU Stern Business School, wp.
- Zhang (2003) What did the credit market expect of Argentina default? Evidence from default swap data; FRB WP 25.