

## RATING AGENCIES AND THE EUROPEAN UNION SOVEREIGN DEBT CRISIS: AN ETHICAL APPROACH

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**Abstract:** Credit ratings have become a key factor in today's financial markets. Their importance influence not only private finances but, also, they influence a country's finances, budget, economic policies, politics, and, in the case of Europe, credit ratings are modeling the whole EU structure and institutional development. Today, credit ratings are affecting the wealth and welfare of entire populations. The possibility of "inside" credit ratings has important economic and social implications and deserves study from an ethical point of view. In the present paper, we analyze the role Credit Rating Agencies (CRAs) in the European Union Sovereign Debt Crisis and its ethical implication. Using a historical, descriptive, and comparative methodology, this paper first presents 1) the development of the European Union sovereign debt crisis, then compares 2) the levels of debt in relevant developed countries, 3) presents the relevance of Rating Agencies in the financial markets, 4) analyzes their role in the European Union Sovereign Debt Crisis, 5) assesses the updating of CRAs regulation, 6) reviews the feedback from governments and other Institutions and 7) draws some conclusions and recommendations.

**Keywords:** credit rating; European Union; debt crisis

### European Union Sovereign Debt Crisis Development

The European Union Sovereign Debt Crisis has been one of the hottest topics debated in news and financial analysis. We aim to study, from an ethical perspective, this subject, and, more specifically, the role that rating agencies play in the development of the events. Let us begin with a brief review of the main events. European countries' debt was not considered an issue until 2010 when came reports indicated that total Eurozone sovereign debt was €7,862 billion. However, most economists "trace the beginning of the European sovereign debt crisis to 5 November 2009, when Greece revealed that its budget deficit was (...) more than twice what the country had previously disclosed" (Voss, 2011). The deep causes of this crisis can be traced to the very structures and players that govern European institutions.<sup>1</sup>

The debt crisis revealed fundamental economic differences between northern and southern European countries. Some Southern European countries have had increasingly high debt levels, higher unemployment, and a loss of competitiveness. Northern Europeans tend to have lower debt levels and don't think they should compensate other countries' wrongdoings. However, there is a consensus among countries in the EU to continue the Union, and all together have to find the solutions. Below is a condensed timeline of the sovereign debt crisis development in Europe.

### *European Sovereign Debt Crisis Timeline*

- **1992**--The Maastricht Treaty was signed, creating the European Union (EU). Its members are

required to: keep low and stable inflation; keep low deficits and debt and have pro-growth policies; have stable exchange rates. The most important factor with regard to the European sovereign debt crisis will prove to be the fiscal requirements.

- **2004**--November 22: Greece admits that it manipulated the government's fiscal convergence criteria in order to gain admittance to the Eurozone.
- **2009**--November 5: Greek Prime Minister announces that Greece's annual budget deficit will be 12.7% of GDP — more than twice the previously announced figure.
  - December 8-22: Fitch and S&P ratings cut Greece's sovereign credit rating to BBB+ from A- with a "negative outlook." Moody's cut it from A2 to A1.
- **2010**--Greece initiates three different austerity packages.
  - Jean-Claude Trichet, President of the European Central Bank (ECB), extends less-restrictive collateral rules.
  - Credit ratings downgraded: Portugal down 2 levels, Spain and Ireland down 1 level, and Greece downgraded to Ba1=junk status.
  - Eurozone nations and the IMF agree to a €110 billion bailout plan. Eurozone nations must provide €80 billion and the IMF €30 billion to help bail out Greece.
  - The Eurozone nations create the European Financial Stability Facility (EFSF) and initially fund it with €440 billion in capital. It is designed to prop up faltering Eurozone economies. The EFSF provided loans to financially needy countries within the Eurozone, recapitalized banks, and bought sovereign debt.<sup>1</sup>
  - Greece, Spain, Italy, and Germany agree to austerity packages.
  - Hungary's Prime Minister announces that it is probable that they will default on their sovereign debt obligations.
  - November 28: Ireland agrees with the IMF and Eurozone members on a €85 billion bailout package.
  - December- Permanent bail-out mechanism established and stronger sanctions agreed upon by the European Council as an amendment to the EU Lisbon Treaty.
- **2011**
  - Strict fiscal rules enforced across the EU.
  - Emergency funding program established-the European Financial Stabilization Mechanism (EFSM).
  - May: Portugal agrees with the IMF and Eurozone members on a €78 billion bailout package.
  - Debt yields across the Eurozone rise dramatically as investors become increasingly skittish about Europe's prospects for resolving its crisis.
- **2012**
  - March 12: The IMF and Eurozone members agree on a €130 billion bailout package for Greece.
  - European Stability Mechanism (ESM) replaces the EFSM and EFSF to become a permanent rescue-funding program.
  - European fiscal union proposes more integration throughout Europe as a central body, and that it has more control over each member state's budget.

--Eurobonds issued by 17 euro nations, excluding the highly oppositional Germany, to help takeover the debt. Investors and economists support Eurobonds and think they are the best way to solve the EU debt crisis.

--November 15: Third quarter gross domestic product (GDP) shrinks 0.1% in the Eurozone. This result compares to a second quarter shrinking of 0.2%. Countries worst hit include: Greece, Italy, Spain, Portugal, Austria, and the Netherlands.

--December 13: After endless negotiations, EU finance ministers announce that they have reached an agreement to form a banking union. A single banking regulator — the ECB — is thought to be a key to resolving this three-year-old crisis. Authority is granted to force troubled banks to close their doors and for bank capital ratios to be raised.<sup>2,3,4</sup>

This chain of events that led up to the sovereign debt crisis in the EU are coupled with the downgrading ratings of several EU nations. The role of the three American-based credit rating agencies in the events is widely debated and is the subject of study of our paper. Currently, the integrity, the reliability and the reputation of Moody's, Standard and Poor's, and Fitch are under debate.

### ***Debt Crisis in Developed Countries***

The causes of the sovereign debt crisis of the last years are a combination of multiple factors that evolved over time. To summarize, we can enumerate the following:

- The globalization of finances
- Easy credit conditions in the US during the 2002–2008 period encouraged high-risk lending practices.
- Easy credit conditions in the EU countries. The adoption of the euro led to many Eurozone countries of different credit worthiness receiving similar and very low interest rates for their bonds during years preceding the crisis. High-risk lending practices became widespread in some countries among consumers, as well as governments.
- The 2007–2008 US generated global financial crisis
- The 2008–2012 global recession
- International trade imbalances
- The bursting of real-estate bubbles
- Government over-expansive fiscal policy choices (revenues and expenses)
- National bail outs of troubled banking and private bondholders. That meant nations assuming private debt and socializing losses

When talking about sovereign debt, we have to distinguish it from household debt and financial institutions debt. Due to high-risk lending practices, the last two were also spiraling and later, due to socialization of losses, accelerated the first. However, even if we are used to hearing about the European Sovereign Debt Crisis and the southern European economies as being the “culprits” of the situation, it is important to note two facts: first, the Sovereign Debt is not reduced to European countries, but is well spread in most OECD economies. Second, inside the EU, high levels of debt are prevalent among most of the economies, including the ones perceived as strong or risk free economies. Let us explain the first point: in effect, according even to The Economist Intelligence Unit, the position of the euro area looked no worse and, in some respects, better than that of the US or the UK. We can state that

- The budget deficit for the euro area as a whole (see graph) is much lower.
- The euro area's government debt/GDP ratio of 86% in 2010 was about the same level as that of the US.
- Between 2000 and 2012\* The euro area's general government financial balances have been consistently over the UK and markedly over the US. (see Figure 1 Figure 2)
- Private-sector indebtedness across the euro area is markedly lower than in the US and UK

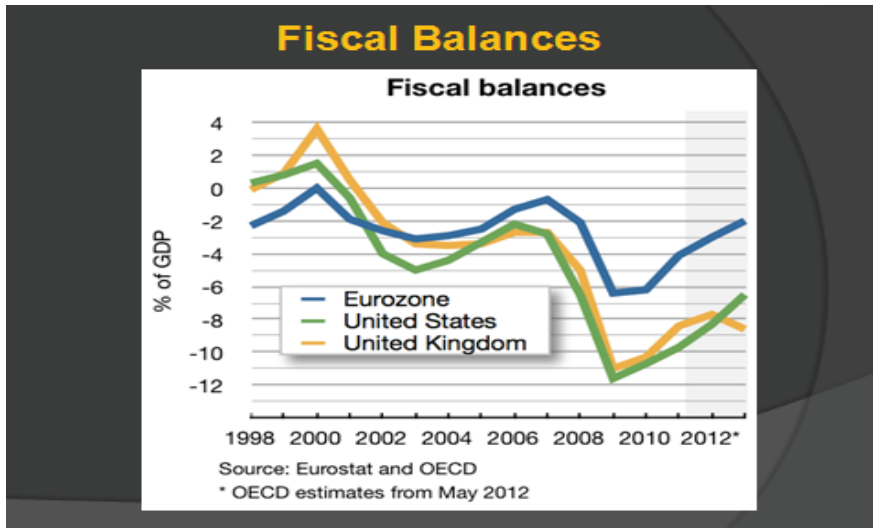


Figure 1. Fiscal Balances

Sources: Wikipedia, European Sovereign Debt Crisis. [http://en.wikipedia.org/wiki/European\\_sovereign-debt\\_crisis](http://en.wikipedia.org/wiki/European_sovereign-debt_crisis)

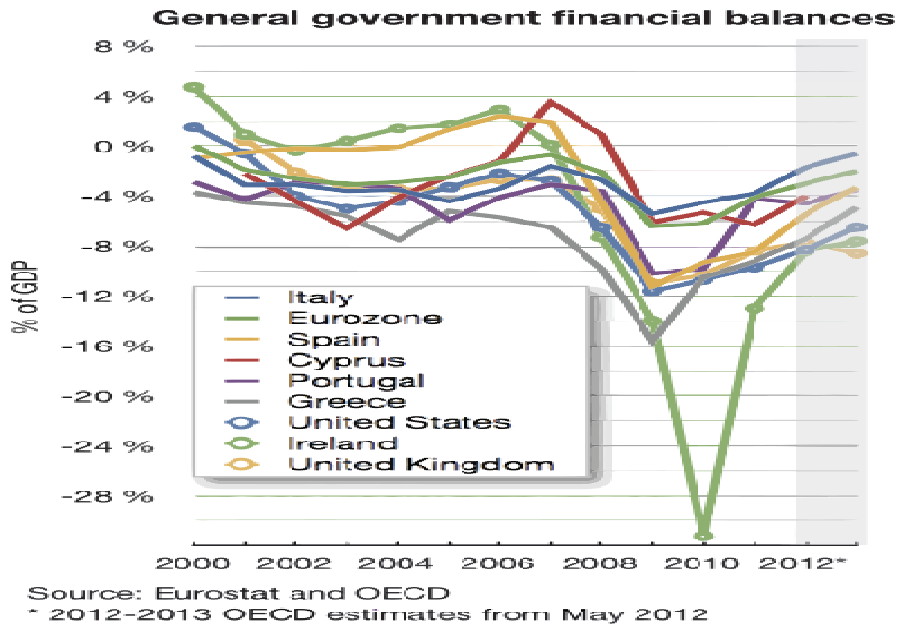


Figure 2. General Government Financial Balances

Source: Wikipedia, European Sovereign Debt Crisis. [http://en.wikipedia.org/wiki/European\\_sovereign-debt\\_crisis](http://en.wikipedia.org/wiki/European_sovereign-debt_crisis)

In absolute terms, the ten main debtor countries in the world are the United States, the United Kingdom, France, Germany, Japan, Italy, Netherlands Spain, Ireland, and Luxembourg. The biggest Eurozone debtors on the ranking are France and Germany, in the third and fourth place, both with around US\$ 5.6 trillions each, the two “core” Eurozone economies. Ahead in the ranking is the UK in second place with US\$ 9,8 trillions, and in the first place is the US with US\$ 16 trillions. The UK is almost double the German or French one, and US debt is triple them. We can conclude that the crisis is extended to all the developed economies. The so called “Eurozone Sovereign Debt Crisis” could probably be more accurately renamed as the “Eurozone Sovereign Rating Crisis,” as we will see as the present study develops.

**Table 1. Ranking of Countries by External Debt**

Rank	Country	Unit: Millions US \$		Unit US \$	
		External Debt	Per Capita	% of GDP	Date
1	<u>United States</u>	16,053,420	51,626	103	10-Nov-12
2	<u>United Kingdom</u>	9,836,000	156,126	390	30-Jun-11
3	<u>France</u>	5,633,000	74,619	182	30-Jun-11
4	<u>Germany</u>	5,624,000	57,755	142	30-Jun-11
5	<u>Japan</u>	2,719,000	19,148	45	30-Jun-11
6	<u>Italy</u>	2,684,000	36,841	108	30 June 2011 est.
7	<u>Netherlands</u>	2,655,489	226,503	344	30-Jun-11
8	<u>Spain</u>	2,570,000	18,260	84	30-Jun-11
9	<u>Ireland</u>	2,352,000	26,820	108.2	30-Sep-11
10	<u>Luxembourg</u>	2,146,000	3,696,467	3,443	30-Jun-11

(Source: Wikipedia, List of countries by external debt.

[http://en.wikipedia.org/wiki/List\\_of\\_countries\\_by\\_external\\_debt](http://en.wikipedia.org/wiki/List_of_countries_by_external_debt) )

Regarding the second fact, in effect, as we can see in Graphic 4, until 2010, the main total debtors in the EU were, in order, Germany, Italy, France, and the UK, the four economies considered to be the core EU countries. The so called “peripheral” European countries' debt seems not to be so peripheral. In terms of debt percentage over GDP, the situation does not depict a two-Europe clear divide. If we except Greece and Iceland, the main debtor as a percentage over is Italy. Portugal and Ireland are slightly over Germany, France and the UK and Spain as the best positioned of the 10 countries reflected. Noteworthy, is the case of the Netherlands which has one of the highest OECD countries debt percentages over GDP (see Table 1). The debt of the so called PIGS (Portugal, Ireland, Greece, and Spain) amounts to only to 6% of the overall Eurozone debt. We cannot endorse the 2-tier vision of the European debt and less the consideration that the debt crisis is confined to Europe.

Public Debt and Debt to GDP - 2010

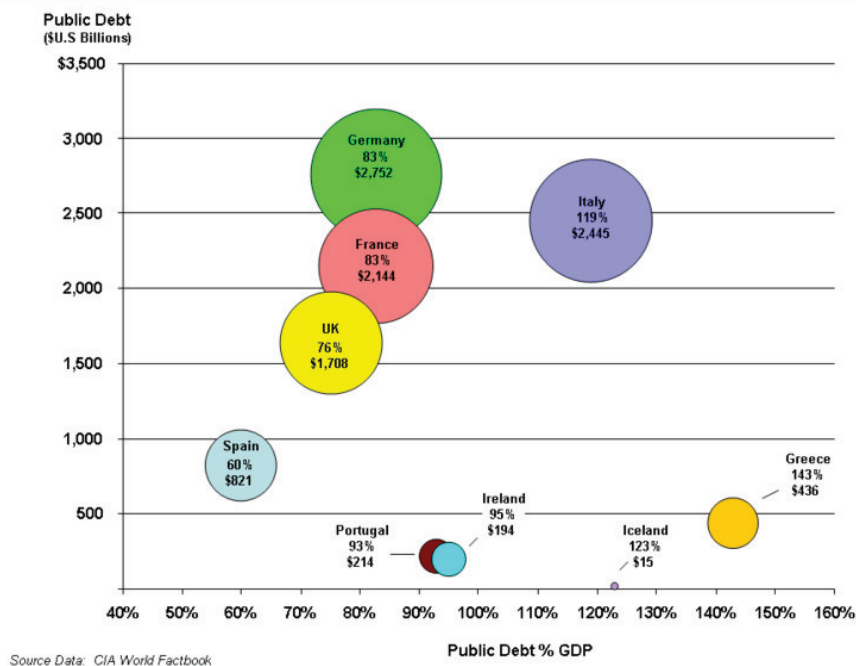


Figure 3. Selected Eurozone Countries 2010 Public Debt

Source: Wikipedia, European Sovereign Debt Crisis. [http://en.wikipedia.org/wiki/European\\_sovereign-debt\\_crisis](http://en.wikipedia.org/wiki/European_sovereign-debt_crisis)

### The Rating Agencies Relevance in European Financial Markets

Rating agencies play a crucial role in financial markets because they are the reference to know about the reliability of bonds and securities. Ratings importance has grown over the years, not only because markets widespread use them, but because in the last few years, regulation has made them mandatory. That is the case of the EU regulatory reliance on credit ratings. The EU adopted in 2005 of the Basel II recommendations and transposed them in European Union law through the Capital Requirements Directive (CRD), which was effective since 2008. This force European banks and, more importantly, the European Central Bank to rely heavily on the assessments of credit risk marketed by the main CRAs. The problem derives from the fact these CRAs are practically reduced to two: the US firms, Moody's, and S&P. In this aspect, the EU Capital Requirements Directive is strengthening anti-competitive duopolistic practices akin to exclusive dealing. European governments surrendered most of their rating regulatory authority in favor of a private cartel non-European and lax regulated.<sup>5</sup>

### The Role of the Rating Agencies and the European Union Sovereign Debt Crisis

During and after the Asian Crisis in the late 90s, the role of the credit rating agencies and the effects of their ratings was very controversial. Some authors, such as Ferri, Liu, and Stiglitz (1999)<sup>6</sup>, have claimed that excessive downgrades on ratings took place then, leading the already struggling national economies into a deeper hole. The 2008 US generated global economic crisis has once again revealed the important role on the economy of the ratings provided by the CRAs and their inaccuracies. As a consequence of rating flaws, whole economies could suffer its effects. When analyzing the causes and effects of the European Sovereign Debt Crisis, with the background of the mentioned experience in Asia, but mainly due to the global economic crisis,

the same questions are again, case of study. What if because of a wrong rating an innocent economy is seriously harmed? Since CRAs are not prone to reveal the real methodology they use to generate their ratings, Gärtner, Griesbach, and Jung (2011)<sup>7</sup> from University of St. Gallen, made a thorough econometric analysis on the effect of CRAs' ratings on government spreads, based on annual data for 27 OECD countries between 1999 and 2010. Using variables, such as rating, GDP growth, GDP per capita, government surplus, government primary surplus, government debt, government bond yield (10-year), credit spread, and inflation, they obtained different models, all of them robust enough, to represent how sovereign debt ratings are formed through the estimation of relationships between ratings and macroeconomic and structural variables.

Then they decomposed actual ratings in two parts: a systematic and an arbitrary part; this one was unexplained by observed previous procedures of CRAs. The third step was the quantification of the effect of each of those two parts of a country's sovereign debt rating on its bond yields in order to evaluate both the endogenous and the discretionary impact of CRAs on the market during the European debt crisis, especially concerning the PIGS (Portugal, Ireland, Greece and Spain) countries. Among the findings of the study are the following:

- Government effectiveness has a significant impact on sovereign debt ratings, while corruption has no explanatory power.
- Income growth has a statistically significant negative impact on sovereign debt ratings, which is strange because higher income by itself should bring lower debt ratio in the future.
- CRAs claim that their ratings are not affected by changes in the business cycle, but in the case of PIGS, the study does not support those claims. It seems that some developing countries not included in the study got over-ratings at the expense of PIGS under-ratings.
- There was no consequence of being a PIGS country before 2009, but after it, they were rated 2.30 notches lower than another country with the same economic fundamentals.
- Modified models are still consistent. About 80% of the predicted sovereign debt ratings are similar to those provided by the CRAs.
- The results suggest that PIGS suffered an excessive downgrade of their rating during the crisis.

The overall conclusion is that the PIGS were rated relatively worse during the crisis than all the other OECD countries of the sample. This flawed rating meant higher spreads on government bonds, further aggravating some European governments' financial situation and creating the so called "European Debt Crisis." Gärtner, Griesbach, and Jung (2011)<sup>8</sup> acknowledge that the PIGS were facing severe, home-originated economic problems, but just because they were targeted as a group, the PIGS group, got lower than neutral ratings and suffered unjustified financial damage that became a self-fulfilling prophecy.

### ***The Impact of Rating on Credit Spreads***

After separating actual ratings into a predicted part due to economic and structural variables, and an unexplained part, and after estimating each influence on the credit spread, it may be seen that markets respond to the unexplained part, which means that CRAs may have a discretionary effect on the interest rates that governments have to pay for credit. From new econometric analysis, the hypothesis that the credit spread is caused by the rating spread cannot be rejected. In fact, the rating spread of 2 of the 4 PIGS was not caused by the credit spread. This sustains that ratings are a relevant variable when obtaining credit spreads. The results

insinuate that CRAs, through increased ratings that may not be assigned to economic fundamentals, may influence interest rates. Both the systematic and the unexplained part are highly significant.

The study has proven that markets and CRAs interpret economic variables in a different way. As the market does, it does not explain the increased credit spread of the PIGS countries, but the unexplained or arbitrary information could explain it. This concludes that CRAs may lead countries with an important debt ratio into serious problems. However, the excessive downgrade is not the only issue concerning CRAs and Europe. The precise moment in which CRAs have divulged the change of ratings has been extremely disruptive some times. As the EU Commissioner for Internal Market and Services, Michel Barnier said, "I have also been surprised by the timings of some sovereign ratings -- for example, ratings announced in the middle of negotiations on an international aid program for a country." "We can't let ratings increase market volatility further." Barnier claims that any agency that "infringes, intentionally or with gross negligence, the CRA Regulation, thereby causing damage to an investor having relied on the rating," should be taken to the courts.<sup>9</sup>

### **CRAS And Regulation**

Due to the responsibility CRA's have since investors, borrowers, issuers and governments worldwide rely on the ratings they provide, and in order to protect investors, governments have realized that tight regulation in the industry is a must, and some measures have been undertaken in the USA and EU. Let us review the main regulatory concerns that have been regulated. In 2006, The US Congress' Credit Rating Agency Reform Act (CRARA) empowered the SEC to regulate CRAs in several aspects, except for their rating methodology. This law required the SEC to establish clear guidelines for determining which credit rating agencies qualify as NRSROs (Nationally Recognized Statistical Rating Agencies). This measure opened up competition to the industry. Concerning transparency and disclosure about CRA's methodologies, conflicts of interest, use of confidential data, performance and commitment to issuers, the International Organization of Securities Commissions launched the 2008 IOSCO CRA Code, of voluntary implementation.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, passed on July 21st, 2010, in its Title IX, known as the "Investor Protections and Improvements to the Regulation of Securities" in the Subtitle C, orders the SEC to create an Office of Credit Ratings (OCR), to supervise NRSROs, and regulate them. Its policies seek transparency and eradication of conflicts of interest. Regulation includes the requirement that rating agencies must, among others document an effective internal control over the implementation and adherence to policies, procedures, and methodologies for determining credit ratings,

- (1) Submit an annual internal control report,
- (2) Adhere to rules, policies, and procedures to avoid conflicts of interest,
- (3) Notify users of identified significant errors,
- (4) Report to authorities valid allegations of illicit conduct by issuers of securities.

It also establishes guidelines for corporate governance, organizational control, and management of conflict of interest. The Commission has authority to suspend or invalidate an NRSRO concerning a particular class of securities if the NRSRO cannot produce ratings with integrity. The OCR must examine each NRSRO at least once a year and must write a public inspection report. The European Union has passed three regulations concerning CRA's since 2009. They are known as CRA1, CRA2 and CRA3 (November 2011). CRA3 changes significantly the CRA Regulation on issues including the dependence



of companies on external credit ratings, sovereign debt ratings, competition within the industry, independence, and civil liability of credit rating agencies. Several proposals have been issued: a mandatory rotation rule that forces financial instruments' issuers to switch the CRA every four years to get their ratings; this is not applicable to small CRAs; issuers of structured finance instruments should engage a minimum of two different CRAs for their ratings. To lessen the probabilities of conflicts of interest, CRAs should make public a shareholder with 25% or above of the capital or voting rights owns at least 25% of the rated entity.

In order to assure the independence of CRAs and their opinions, there would exist the prohibition of having more than 25% or more of the capital or the voting rights in more than one CRA. Furthermore, if a shareholder had at least 5% of the capital or the voting rights in more than one CRA, he would have to divulge publicly his ownership in each other. If investors or issuers suffered damage due to an infringement committed by the CRA, either intentionally or with negligence, they could claim damages from the CRA. Sovereign ratings should be reviewed a minimum of every six months (instead of every 12 months as it is now under general rules).

ESMA (European Securities and Market Authority) took over the supervision of CRAs in the EU in July, 2011. It is the regulator of CRAs in the EU, exclusively responsible for the registration and ongoing supervision of CRAs. ESMA is responsible for the registration of CRAs that operate in the EU; the supervision of registered CRAs, that is monitoring of CRA compliance with the CRA Regulation; taking supervisory measures and imposing fines in CRA Regulation infringement; submitting draft regulatory technical standards for endorsement by the European Commission; and assessing of third country regimes under the endorsement and certification provisions.

After a long period of lax regulations and enforcement, it is apparent the CRAs regulation reforms are on the fast track. Regulations are considering enforcement and legal liabilities in case of wrongdoings. At the same time, implementation --or explanation of non-compliance-- with the IOSCO Code of Conduct in CRAs own code is expected. Supervision Entities or Committees have been created or assigned, although at the present time we cannot yet extract any assessment regarding their efficiency on real performance due to lack of relevant data.

We do assess that US and EU regulation reforms are taking divergent orientations. Although both enforce transparency and organizational requirements to prevent conflicts of interest and corporate governance, the EU is much stricter in the sense that it encourages strict supervision of methodologies and rating results and stresses detailed CRAs civil liability penalizations and the agencies' registration requirements. The US SEC cannot "interfere" with ratings and methodologies. The US framework seems less advanced, is less regulated, and operates through market competence.

The big effort that is being made on regulatory issues must be recognized. The fact of being behind the CRAs activities helped the sub-prime crisis to arise. After 2008, both legislators and markets realized tougher regulation and supervision is a must. However, we shall recall that even with regulation and enforcement, law infringements cannot be fully prevented. Codes of conduct, encouragement of best practices, and having an ethical mindset are also needed in the professionals in the industry to prevent harmful practices.

The main objective of the IOSCO Code Fundamentals is to guarantee investor protection by assuring the integrity of the rating process. It is divided in four sections: The Quality and Integrity of the Rating

Process, CRA Independence and the Avoidance of Conflicts of Interest, CRA Responsibilities to the Investing Public and Issuers, and Disclosure of the Code of Conduct and Communication with Market Participants.<sup>10</sup> Regarding each of the sections, the following need to be considered:

**The Quality and Integrity of the Rating Process** requires, among other things, that procedures (1) be written based on a thorough analysis of relevant data; (2) have rigorous methodologies; (3) have qualified personnel; (4) CRAs should keep internal records and have enough resources to carry out high-quality credit assessments; (5) there should be periodical review of methodologies and models; (6) there need to be monitoring and updates of the ratings; (7) CRA's analysts should be held to high standards of integrity.

**CRA Independence and the Avoidance of Conflicts of Interest**, for example says that "A CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses, that may present a conflict of interest."

**CRA Responsibilities to the Investing Public and Issuers**, deals with transparency ("A CRA should publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the CRA." ) and the treatment of confidential information.

**Disclosure of the Code of Conduct and Communication with Market Participants.** "A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data."

### ***The Feedback from Government and Other Institutions***

The influence that sovereign debt ratings have had over sovereign bond interests, the bulk of the sovereign debt amount, and its repercussion on some European government financial expenditures have prompted a widespread response among European governments. Policy makers have criticized ratings agencies for acting politically, accusing the Big Three of bias towards European assets and fueling speculation. Moody's decision to downgrade Portugal's foreign debt to the category Ba2 "junk" infuriated officials from the EU, especially Portugal.<sup>11</sup> State-owned utility and infrastructure companies in energy, airports and highways were also downgraded despite claims to having solid financial profiles and significant foreign revenue.

French central bank chief Christian Noyer criticized the decision of Standard & Poor's to lower the rating of France but not that of the United Kingdom, which "has more deficits, as much debt, more inflation, less growth than us." Similar comments were made by high-ranking politicians in Germany. Michael Fuchs, deputy leader of the leading Christian Democrats, said: "Standard and Poor's must stop playing politics. Why doesn't it act on the highly indebted United States or highly indebted Britain?" adding that the latter's collective private and public sector debts are the largest in Europe. He further added: "If the agency downgrades France, it should also downgrade Britain in order to be consistent."<sup>12</sup> Credit rating agencies were also accused of bullying politicians by systematically downgrading Eurozone countries just before important European Council meetings. One EU source noted that downgrading timings coincided the weeks of summits.<sup>13</sup>

Initial criticism has turned into action directed to create new alternative rating agencies. Those initiatives range from government-sponsored, private market initiatives and people-backed initiatives. In Europe in 2010, Germany's foreign minister called for an "independent" European ratings agency, which could avoid the conflicts of interest that he claimed US-based agencies faced.<sup>14</sup> European leaders are studying the possibility of setting up a European ratings agency in order that the private U.S.-based ratings agencies have less influence

on European financial markets.<sup>15, 16</sup> The German consultant company Roland Berger is collecting funds to set up an independent, non-profit ratings agency by mid 2012. According to the company, setting up a new ratings agency would cost €300 million.<sup>17</sup> Another group, Bertelsmann Stiftung, presented a plan for establishing an international non-profit credit rating agency (INCRA) for sovereign debt.<sup>18</sup>

China bolstered the activity of a locally based rating agency, the Dagong Global Credit Rating (大公国际资信评估有限公司). Dagong became notorious in 2010 and 2011 for giving the US debt lower credit ratings than those given by the three traditional rating agencies, Moody's, Standard and Poor's and Fitch.<sup>19</sup> The ratings assigned by Dagong to the U.S., the UK, France, Belgium, Italy, and Spain were significantly lower than those given by the three traditional rating agencies, but the major emerging countries ratings were significantly higher.<sup>20</sup> It is interesting to point that the U.S. Securities and Exchange Commission has refused to recognize Dagong's ratings.

Dagong is currently tying up with US and Russian partners to form a new group. The Chinese firm will set up the joint venture with Egan-Jones Ratings Co. (EJR), based in Pennsylvania, and Russia's RusRating JSC. The joint venture, called Universal Credit Rating Group, will engage in global ratings affairs.<sup>21</sup> Other initiatives started in developing regions. Three of them, Global Credit Rating Co. (Africa), Pacific Credit Rating Co. (Latin America) and JCR/VIS Credit Rating Co. (Asia), are joining efforts to create the International Ratings Group, with the goal to create a single agency covering all the emerging markets: Africa, Middle East, Eastern Europe, South America and Asia.<sup>22</sup> Another innovative initiative is a web collaborative rating agency based on transparency, participation, and the concept of collective intelligence, called Wikirating. The contents are based on participation, and it diffuses its methodology and sources of information. Wikirating conducts ratings through cyber-polls and also elaborates its own index, The Sovereign Wikirating Index (SWI) is based on a formal methodology.<sup>23</sup>

Wikirating results show big disparities with traditional ratings. In the case of the US, while S & P rates it AA +, Wikirating grades the US BBB-(the last step before the "non-investment grade"); however, a country like Bolivia is rated above the US. Many of the new agencies are in compliance with the IOSCO CRA Code or intend to be so in the near future<sup>24</sup>. The International Organization of Securities Commissions (2009) point out that a number of factors that may have contributed to this, including the proposed EU regulations.

### **Conclusion and Recommendations**

The role of credit ratings agencies (CRAs) in the latest financial crisis has been very controversial. After some evidence of wrongdoings in the 1997 Asian Financial Crisis, the role of (CRAs) in the US generated 2008 World Financial Crisis has been widely studied and analyzed. The studies highlighted flagrant conflict of interests and the lack of proper regulation and government control, resulting in an urge for a regulatory reform and control enhancement that has been taking place since 2010, especially with the passing of the US Dodd-Frank Wall Street Reform and Consumer Protection Act.

Since the end of 2010, we have been witnessing another financial crisis, the European Union Sovereign Debt Crisis that started at the end of 2010 and it is yet unfolding. This is a new phenomenon much less studied from the CRAs point of view. Parallelism and differences between both crises can be established. In both crises, CRAs were involved and had an important role, but while in 2008 the financial products that caused the crisis were private CDOs (Collateralized Debt Obligations) created and commercialized by investment banks that had previously paid CRAs to rate it in an unethical situation of conflict of interests, in the 2010 crisis the

rated were sovereign bonds and the sovereign countries that issued them. In 2008, the problem was over-rating (Lehman Brothers was rated AAA almost until a few days before its bankruptcy); in 2010 the problem may very well be under-rating.

In the first case issuers, investment banking institution were ordering the ratings. It was in their interest that ratings were as high as possible in order to market the financial products they created. In the European case, it is just the opposite; financial institutions are the creditors and are direct beneficiaries of low credit ratings. The lower the ratings are, the higher the yields are. Given that new regulation and its implementation were focused at addressing former problems, we are tempted to suspect that a new form of conflict of interest may have evolved, also concerning CRAs and financial institutions, that tend to produce ratings lower than reality.

Rating results are a key factor in Europe Sovereign Debt Crisis. They are important not only in private finances, but they influence a country's finances, budget, economic policies, and politics and are modeling the whole EU structure and institutional development. Europe Sovereign Debt rating is affecting the wealth and welfare of entire populations. The slight possibility of conflict of interest or, to use another term, "*inside*" credit ratings, deserves to devote resources to conduct thorough technical research on the subject. Technical conclusions may pave the way not only for new regulation but also for a new ethical evaluation and understanding of the phenomenon. The conclusions and recommendations can be summarized as follows:

- Regulation of CRA's is a crucial factor for the accountability of CRAs. Governments and lawmakers understood the need and reacted, although it seems that the pace and extent of changes goes behind the evolution of markets.
- Regulation change is always a response to evolving situations. No regulation can be effective if there is no deep understanding of the market mechanism and its flaws. No deep understanding can be achieved if governments don't conduct thorough technical research to spot the flaws.
- Establish a '*supranational*' body of regulation. Although CRAs may be located and accredited in a particular country, the products rated may be issued in one or more different countries, and investors may probably be scattered all over the world. Rating is no longer just an in-country activity but a global one. National regulation and enforcement will lose its efficacy if it is issued by individual countries. An agreement between the main player nations will be needed in order to establish a supranational body of regulation.
- The Importance of enforcement and supervision can never be neglected. No matter what, regulations need to be enforced and supervised.
- It is important that the methodology used to issue the ratings is included in the regulation and supervision. According to US Law, there is an obligation to report the methods and procedures, but this doesn't mean that methods and procedures are regulated. Given the evolving nature of the science, the computation algorithms used in ratings are constantly progressing. That makes methodology regulation a difficult task. Regulation should be considered an ongoing activity, hand in hand with advanced research.
- In case of proven responsibility, liabilities provisions should be included and specified. EU legislation is more evolved in this aspect. Liabilities evidence is, again, the need of a supranational law frame and supervisory institutions.
- Promote application of best practices in the industry as a complement to regulation and as a

necessary bridge between regulation and ethical values.

- The promotion of ethical values is important to prevent and avoid injustice. Most rating agencies have already adopted a code of ethics, but their implementation is left to themselves. Transparency and supervision will be fundamental for sound implementation.
- Empower financial customers and their associations to pressure 1) law enforcement, 2) best practices and 3) ethics codes implementation and accountability

## Notes

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<sup>3</sup> [www.publicserviceeurope.com](http://www.publicserviceeurope.com)

<sup>4</sup> <http://www.investopedia.com/financial-edge/0912/the-eurozone-crisis-and-aaa-ratings.aspx>

<sup>5</sup> M. Nicolas J. Firzli, "A Critique of the Basel Committee on Banking Supervision" *Revue Analyse Financière*, 10 Nov. 2011/Q1 2012

<sup>6</sup> Ferri, G., Liu, L.-G., & Stiglitz, J. E. (1999). The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis, *Economic Notes*, 28(3), 335-355.

<sup>7</sup> <http://www1.vwa.unisg.ch/RePEc/usg/econwp/EWP-1106.pdf>

<sup>8</sup> <http://www1.vwa.unisg.ch/RePEc/usg/econwp/EWP-1106.pdf>

<sup>9</sup> <http://www.bbc.co.uk/news/business-15739234>

<sup>10</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>

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<sup>14</sup> "FT.com / Europe – Rethink on rating agencies urged". *Financial Times*. Retrieved 2 May 2010.

<sup>15</sup> *BusinessWeek*. "EU Gets Tough on Credit-Rating Agencies".

<sup>16</sup> "European indecision: Why is Germany talking about a European Monetary Fund?".

<sup>17</sup> *BusinessWeek*. "EU Gets Tough on Credit-Rating Agencies".

<sup>18</sup> Chinese agency downgrades U.S. credit rating

<sup>19</sup> Business Spectator, China's Dagong to unveil new ratings agency

<http://www.businessspectator.com.au/bs.nsf/Article/Dagong-to-unveil-new-ratings-agency-ZCDLS?opendocument&src=rss> Oct 2012

<sup>20</sup> [http://en.wikipedia.org/wiki/International\\_Ratings\\_Group](http://en.wikipedia.org/wiki/International_Ratings_Group)

<sup>21</sup> Wikirating, the collaborative rating agency,

<http://www.another-rating.org/2012/03/wikirating-collaborative-rating-agency.html>

<sup>22</sup> International Organization of Securities Commissions Media release April 2009

<sup>23</sup> Wikirating, the collaborative rating agency,

<http://www.another-rating.org/2012/03/wikirating-collaborative-rating-agency.html>

<sup>24</sup> International Organization of Securities Commissions Media release April 2009

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