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Hard to credit

Sovereign debt Amid the eurozone's woes, a battle is afoot between rating agencies responsible for downgrades and governments that are both regulator and client, write **Richard Milne** and **David Oakley**

George Papaconstantinou has a lot on his plate at the moment. In recent days, the Greek finance minister has launched a €50bn privatisation programme, brushed aside another setback in the battle against chronically weak tax collection and had to fight off investors' perception of an impending debt default.

But this month he still found time to issue an extraordinary two-page diatribe againsts Moody's, the US credit rating agency, for a decision to downgrade Greece to the same level as that of rivals Standard & Poor's: B1 or B plus, a rating meaning "highly speculative" and well below investment grade. Athens called the move "unjustified" and "incomprehensible".

The most vitriolic passage was left to the end: "Ultimately, Moody's downgrading of Greece's debt reveals more about the misaligned incentives and the lack of accountability of credit rating agencies than the genuine state or prospects of the Greek economy. Having completely missed the build-up of risk that led to the global financial crisis in 2008, the rating agencies are now competing with each other to be the first to identify risks that will lead to the next crisis."

Rating weightings

Government credit ratings take into account three main elements. These are public debt as a percentage of gross domestic product, the budget deficit (the amount government spending exceeds income) and debt affordability (interest costs as a percentage of revenue). Germany, with a triple A rating, has a debt-to-GDP ratio of 73 per cent, a deficit of 3 per cent and a debt affordability ratio of 5 per cent. B plus rated Greece has debt-to-GDP at 127 per cent, a deficit of 15 per cent and debt affordability on 15 per cent.

Europe's sovereign debt crisis hit a new peak last week as Portugal slipped ever closer to becoming the next country after Greece and Ireland to need an international bail-out. For Jim Reid, credit strategist at Deutsche Bank, government debt across the developed world is "the last chain in the rolling supercycle of bubbles".

So it is little wonder that a battle is taking place between governments and rating agencies. It is playing out not just in the continual trickle of downgrades – Japan, Portugal, Spain and Greece are among countries to have suffered one this year – but also through stiffer regulation of the sector. Both Europe and the US have enacted new rules for the agencies, which initially embraced the reforms. But new proposals from Brussels, which include giving governments 72 hours' notice of any downgrade, have sparked widespread alarm.

The result will have big implications for governments and investors globally. Governments are the biggest borrowers in the capital market, issuing more than $8,000bn of debt – 62 per cent of the total – in 2009, according to Moody's. And it is not just the debt loads of "peripheral" nations in Europe that cause concern; some investors are already thinking about the fate of larger western economies such as the US and UK.

"This tension [between countries and rating agencies] will be a feature of investment markets particularly in the developed world for some time, including in the US over the long term," says David Leduc of Standish, a US fund manager.

After accusations of having been too soft on the causes of the financial crisis, rating agencies are now being blamed by governments for being too tough. "There is an irony there. In the real world, rating agencies do fulfil a role: they are important in providing a risk-free rate which corporate [borrowers] price off," says Nick Gartside of JPMorgan Asset Management.

Part of the criticism in the crisis was that as rating agencies are paid by issuers, that set-up led to big conflicts of interest that kept ratings artificially high. But most governments pay for their own ratings as well, limiting that line of attack (some such as Germany do not, but agencies still rate them as they are so important to financial markets).

The criticism of credit ratings is hardly new. As an S&P executive wearily notes: "Nobody ever complains about being upgraded." Jacques Cailloux, chief European economist at RBS, is reminded of the Asian economic crisis in the late 1990s. "The debate over the rating agencies was similar in the aftermath of the Asian crisis. We do not seem to have moved on, which perhaps highlights how difficult this problem is to tackle."

Moreover, the ferocity of the sovereign ratings debate is by now well established. After Spain's recent downgrade, Jean-Claude Juncker, the Luxembourg leader who chairs the group of eurozone finance ministers, declared himself "not happy" with the role of rating agencies. Mr Papaconstantinou himself says: "The credit rating agencies are reacting to the markets and then the markets are reacting to the rating agencies. You have a vicious circle."

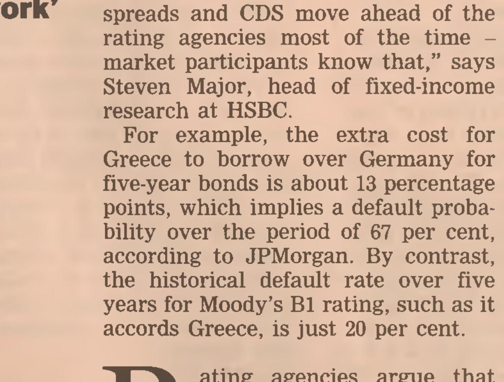
'In a perfect world, rating agencies would be irrelevant, as investors would use their own analysis. But a lot of funds are too lazy to do their homework'

Gary Jenkins of Evolution Securities notes that Moody's downgraded Greece by nine notches in the space of 440 days. He contrasts that with the average length of time a company spends at each of those levels, saying on that basis it should have taken closer to 35 years. "Nobody's credit, whether it be a company or sovereign, changes that quickly," says Colleen Denzler of Janus Capital Management, a US fund manager.

But many investors complain that rating agencies actually go too slowly, arguing that market-based ratings derived from bond prices or credit default swaps – derivatives betting on a country or company defaulting on its debt – are more timely. "It is a well-established fact that bond spreads and CDS move ahead of the rating agencies most of the time – market participants know that," says Steven Major, head of fixed-income research at HSBC.

For example, the extra cost for Greece to borrow over Germany for five-year bonds is about 13 percentage points, which implies a default probability over the period of 67 per cent, according to JPMorgan. By contrast, the historical default rate over five years for Moody's B1 rating, such as it accords Greece, is just 20 per cent.

Rating agencies argue that the debate about whether they are going too fast or too slow suggests they are about right. David Beers, head of sovereign ratings at S&P, says that bond and CDS spreads often undershoot or overshoot: "Sovereign ratings can only be evaluated by their correlation over time with defaults, not with market prices, and studies have repeatedly shown they have an excellent track record." He cites as evidence recent International Monetary Fund research showing that all sovereigns that defaulted since 1975 "had sub-investment grade ratings at least a year before default."

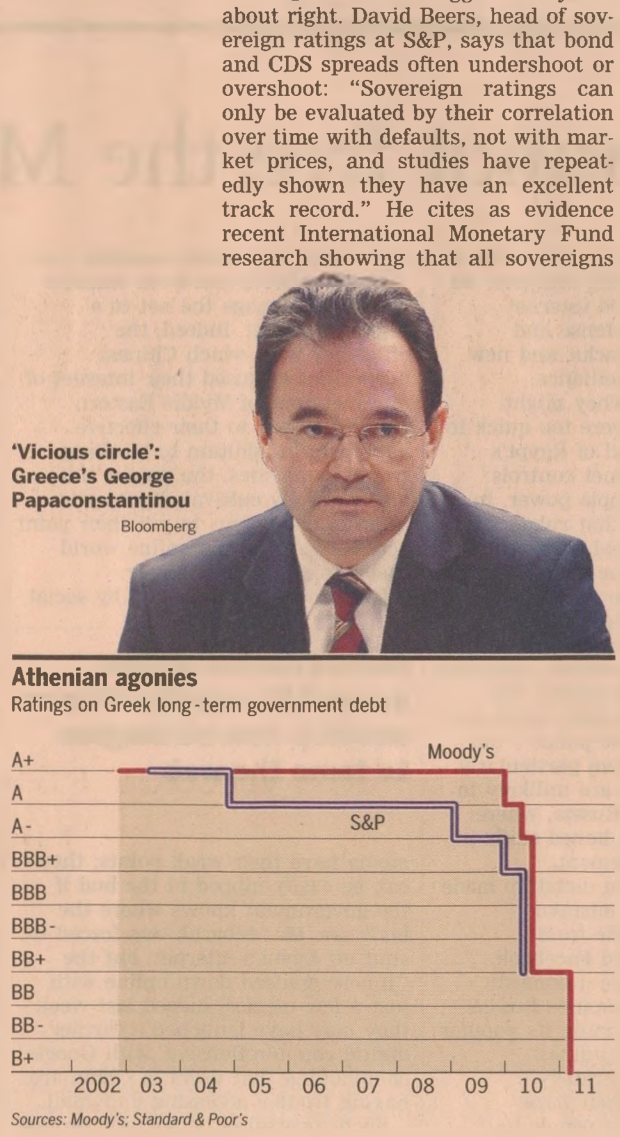


'Vicious circle': Greece's George Papaconstantinou

Bloomberg

Athenian agonies

Ratings on Greek long-term government debt



Sources: Moody's; Standard & Poor's

Looking at the history of the 12-year-old eurozone, it is easy to conclude that both investors and rating agencies were overoptimistic about the prospects of many peripheral economies, judging them little different from Germany at times. The idea that eurozone economies were converging after the introduction of the single currency became popular and some countries were able to fund themselves more cheaply than Germany even as recently as 2007.

But distinctions were drawn by some. S&P downgraded Greece to BBB plus, the eighth-highest rating, in December 2009 – before the full eurozone crisis erupted – while Moody's days later downgraded the country to A2, the sixth-best level.

Charles Wyplosz of the Graduate Institute of International Studies in Geneva says problems lie not just with the rating agencies but also with the herd instincts of financial markets that react too strongly to downgrades. This creates the impression that the agencies are to blame for the resulting volatility. "This herd behaviour is bad – but inherent to financial markets. Once you borrow from the markets, you have to accept this. If Greece did not have a large public debt, the rating agencies would not downgrade it. And if they did, it would hardly matter," Prof Wyplosz says.

One thing all sides agree on is the need to reduce the reliance on ratings, which is often embedded in financial regulation around the world. Bank capital and insurance rules as well as debt indices are frequently based on credit ratings. Rating agencies themselves are keen to end this reliance, not least because of the possibility of being sued by people who trusted them too much.

Many investors in turn argue that the debate on ratings shows why they should invest in their own research. "Ultimately, investors have to get their hands dirty: you have to do your own homework," says Mr Gartside. Ms Denzler says she often avoids the biggest companies or countries in certain indices because the borrowers are so sensitive to their ratings. "We underweight them," she adds.

But the importance of agencies is unlikely to die away quickly. Many investment groups and even some central banks lack the manpower to conduct extensive credit research. Even Pimco, one of the world's largest bond investors, says it can only really afford to research the biggest economies in the eurozone, down to Italy and Spain. That means countries in the periphery or even top-rated ones such as Finland or the Netherlands can slip through the net.

In a world in which eurozone countries are increasingly seen as heterogenous, investors need to understand not just budgetary and financial matters but even the internal politics of each nation. Another complicating factor after the financial crisis is the blurred line between public sector liabilities and those of banks, after many governments guaranteed the debt of their financial institutions.

"In the perfect world, rating agencies would be irrelevant, as investors would use their own research and analysis. But a lot of funds do not have the resources or are too lazy to do their own homework," says the head of sovereign analysis at a large European hedge fund.

The big difference in this debate over credit ratings compared with previous ones is that governments are issuing not just criticisms but regulations too. European rules came into force last year that force rating agencies to register with authorities and be more transparent about how they calculate ratings. The US also moved to regulate agencies after the financial crisis.

But Europe in recent months has suggested it could go much further. Proposals have included a new European rating agency, civil liability for ratings and efforts to boost competition in a sector dominated by Moody's and S&P with Fitch in third place. "Anything that improves their transparency, that leads to more competition for the agencies, I'm all in favour of," says Mr Papaconstantinou.

Among the most controversial suggestions is that agencies should have to inform governments (but not companies) three days before any change in rating. "The adoption of measures that could be perceived as creating a bias in EU sovereign ratings would taint the quality and credibility of ratings," says Michel Madelain, president of Moody's.

Investors are also concerned at any attempt to single out governments for special treatment. "Regardless of the need to do your homework, the independence of ratings benefits everyone in capital markets, even sovereigns," says Mr Leduc. The worry is that agencies could grow scared of cutting ratings for fear of provoking a stronger regulatory response.

"They have to tread a fine line. If they irritate governments too much, they could get further regulation that writes them out of the picture," says Dan Morris, a strategist at JPMorgan Asset Management.

That theory is likely to be tested in coming months. On top of this month's downgrades by Moody's of Portugal, Greece and Spain, S&P on Friday cut Portugal's rating further to triple B, just two notches above junk. It warned that another cut was possible. Markets are braced for a potential S&P downgrade of Greece too. The agency is worried about how the European Stability Mechanism, the eurozone's future bail-out mechanism, could impose losses on bondholders of a country that tapped it.

The rating agencies continue to insist that if their views on creditworthiness change, they will change the rating accordingly, and promptly. But the political pressure is unlikely to slacken. Mr Papaconstantinou believes the agencies are competing with each other to be more pessimistic: "It is as if they are trying to make up for keeping us on a higher rating, almost to be ahead of the pack."

Such talk makes independent observers nervous. Mr Morris says: "Rating agencies are an easy scapegoat. Almost inevitably there will be an overreaction. Their influence will probably be regulated down, which will be a problem ultimately."

After the global crisis

'No evidence of a fall in use of ratings, nor of newer agencies gaining traction'

When Warren Buffett appeared before the US Financial Crisis Inquiry Commission last year, the fabled investor was quizzed about credit rating agencies. The failings of Moody's, in which Mr Buffett's Berkshire Hathaway was the largest shareholder, were the topic of discussion.

To the surprise of some, Mr Buffett came to the company's defence. Although Moody's "made the wrong call", he did not believe it should be singled out for failing to predict that the US housing market could collapse.

The shortcomings of US credit rating agencies – which assigned top triple A ratings to hundreds of billions of dollars of securities linked to US mortgages that turned out to be toxic – are well documented. Many politicians, analysts and investors have a less charitable view than Mr Buffett of the record of Moody's, Standard & Poor's, and Fitch, the three biggest.

However, since those hearings in June 2010, Moody's has done quite well. Its share price has risen by more than 70 per cent. Its ratings continue to be included in nearly every bond or loan that is sold in the capital markets. Last year it was even able to increase prices for assigning ratings – demonstrating it still has the pricing power that drew Mr Buffett to the company.

"Improving fundamentals, manageable regulatory challenges and fading litigation risk ... make Moody's our favourite investment story," said Peter Appert, senior research analyst at Piper Jaffray, in a recent report. "Importantly, we see no evidence of diminished use of ratings in the debt markets nor any evidence that newer [credit rating agencies] are gaining traction from a market share standpoint."

According to a January report from the Securities and Exchange Commission, Fitch, Moody's and S&P have issued around 97 per cent of all outstanding credit ratings. The agencies have changed internal procedures and created stricter divisions between the business side and the ratings side, to manage potential conflicts of interest that arise from the sellers of debt paying for ratings. Their basic business model has not changed, however.

New legislation in the US could gradually shift the debt markets away from the big rating agencies. Much will depend on how regulators write the detailed rules that will flesh out the Dodd-Frank reform legislation enacted last year.

"Dodd-Frank eliminated the pieces of law that mandated the use of ratings and told the various financial regulatory agencies that they should eliminate the use of ratings in regulatory requirements," says Lawrence White, professor at NYU Stern. "This can't happen overnight, but eventually ... the role of these three particular [rating agencies] will diminish."

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