Taming the Agencies: A democratic, accountable and transparent credit rating system

Declaration adopted by the PES Presidency on 6 October 2011[1]

Credit Rating Agencies (CRAs) have become a major factor of instability. Since the beginning of the Eurozone debt crisis, the 3 agencies, which control 95% of the market (Moody's, Standard and Poor's (S&P) and Fitch) have effectively been dictating economic policy to EU Member States. This is not to say that CRAs are entirely responsible for the eurozone debt crisis, but their biased judgments and excessive power have certainly made it worse.

A number of member states need structural changes to correct the factors that created the conditions for the crisis. But to do that requires governments to have enough room to manoeuver and to be able to have comprehensive democratic control of their economic and fiscal policy tools. Yet because of successive downgrades and rising interest rates, sovereign states, individually, and collectively, have seen a drastic reduction in their scope to formulate economic policy. This situation needs to be addressed by EU policymakers. For the sake of our economies, of our societies, and of our democracies.

Wholly detached from their accountability, transparency and even accuracy of their decisions, the power of Credit Rating Agencies (CRAs) has grown dramatically in the last decades. **Unaccountable to the people and their democratically elected representatives**, they answer only to their basic short-term needs, which are driven solely by profit. In the decade preceding the current crisis, large CRA revenues rose by as much as 900% and according to Nobel Prize laureate Joe Stiglitz, **the subprime crisis would not have happened without their contribution**. From their role in fuelling the subprime bubble, to Standard & Poor's $2 trillion calculation "error" that led to the US downgrade, **the need for a reform of the rating system has become more apparent than ever**.

Since the crisis, CRA actions have been rife with inconsistencies. Recent **ratings of many sovereign debts have been subsequently proven to be inaccurate**. Questions over the impartiality of the ratings have remained. The CRA were unable to assess consistently all available information, institutional structure of the Eurozone and political context of potential payment defaults.

Our demands for fixing credit rating

Our response is twofold. We must take immediate regulatory measures to tackle the most urgent problems of the private credit-rating system. In the long run, the creation of a European Independent Credit Rating Agency (EICRA) would be an important step in addressing all the flaws of the credit rating system.

Measures that can and must be taken immediately include:

- **Tackling the conflict of interest:** Issuers of rated financial products choose their agency according to the probability of getting a good rating. Because CRAs rely on fees paid by those who are being rated rather than by those who use ratings, their business model is

[1] The British Labour Party does not sign up to this declaration

flawed with potential conflict of interest. To circumvent this, the rating models and methodology used by CRAs must be disclosed to the public. Only widespread transparency can avoid preferential treatment of certain issuers. Moreover, potential conflicts of interest also arise from the ownership structure of CRAs which are largely owned by financial institution that rely on credit rating in their day-to-day business.

- **Transparency:** Credible and democratic credit rating requires the highest level of transparency. Furthermore, states, unlike companies, can never go bankrupt. The rating of states has far greater consequences than the rating of individual companies. For these reasons the rating of states and the rating of companies must rely on clearly differentiated criteria.

- **Fighting markets concentration:** Only three US-based CRAs share 95% of the global market. Moreover, these three supposedly competing agencies are largely owned by the same shareholders. The degree of their abnormal profit – above 40% of their revenues – is evidence of their market dominance, and indicates potential market abuse that must be investigated and, if appropriate, corrected. The European Commission must use its unequivocal mandate in this respect and launch an investigation without delays.

- **Compare CRAs' accuracy:** In the short run a publicly accessible register of CRAs' past performances can be created, in order to enable regulators to assign obligatory rating according to the CRAs' accuracy, not their market position. Systems of double-ratings can also be used to limit the influence of single CRAs.

- **Giving regulatory power back to the regulator:** Since the 1970s, governments have literally outsourced their risk assessment capacities to private CRAs. This in turns has transformed the rating of private CRAs from opinions into rulings. CRAs representatives have repeatedly claimed that they do not want this responsibility. Public institutions must favour their own risk assessments and rely in later stages on EICRA.

These measures are a first answer to fixing credit rating. However, in order to fully address the reliance of the current regulatory system on private CRAs, the oligopolistic structure of the market and the inherent conflict of interest, an independent alternative to private credit rating is necessary. The PES supports the creation of a European Independent Credit Rating Agency. Fully autonomous from both the market and governments, the EICRA would **reduce information asymmetry in the global market, promote transparency and accountability of the current system and generate reliable information on creditworthiness** for regulatory and supervisory purposes. It should have the following characteristics:

- It would rate both private and sovereign issuers and products. It would be **financed independently and would thus eliminate entirely conflicts of interest** inherent to the issuer-pays model.

- Its rating model would take into account **economic growth, job creation and long-term solvability independent of business cycles**. It would be democratically adopted by the European Parliament and the Council. This would reduce the strictly pro-cyclical effect of private rating and would not push issuers and credit products into a spiral of downgrades and rising yields.

- In the near future, the rating delivered by EICRA should be **the only measure of risk internalised by European regulators and central bank**. In turns, EICRA ratings would be established as a benchmark for European public pension funds and other public investment institutions.

Reforming the current system of credit rating is an essential part of our strategy to regulate financial markets so that finance can become a true contributor to growth and jobs. This reform of the financial sector is an integral part of the PES progressive and fair solution to the crisis.