

Super rating agency

Mortgage Financial Gazette

Speaker's Corner

July 2010



Stewart Hotston

Will the new credit rating agency regulation be the thin end of the wedge? asks Stewart Hotston of Hatfield Philips

Credit ratings agencies have never been top of the Christmas card list for many companies, or indeed countries, but since the start of the global credit crunch the backlash against them, coming from all sectors of the market, has been severe.

As world leaders prepared for the G20 meeting at the end of June the EU announced amendments to Regulation 1060/2009, commonly referred to as Credit Rating Agency Regulation.

Control

At this stage the amendments are fairly benign and very specific, as will be discussed later. What interests me is, whether this is the beginning of a much broader control of how ratings are awarded to financial derivatives, how ratings are integrated into the financial regulatory framework and possibly an attempt at standardisation of practices across the industry.

At this juncture I should say I find mathematics fascinating, and proudly accepting the label of geek, I have watched the slow unfolding of the credit crunch with a grim certainty that the methodologies used to assess financial instruments would similarly be thrust into uncertainty. No single approach has been left unrevised, unreviewed or unexamined. Frequently the changes announced publicly have served only to further undermine confidence in the whole ratings process as the basis for such revisions remain opaque or come on the back of public censure.

Interminable discussion continues on the consistency of ratings in different asset classes at different times by different people using different models. However, despite growing evidence that a substantial minority of market participants are now simply ignoring ratings entirely they, and the agencies who produce them, remain written into the heart of the financial system.

At the heart of EU Commissioner Michel Barnier's proposal is a recognition of the problem of accountability. Rating agencies wield huge power, their ratings are at the core of the Basel Accords, but with very little external control. There is also the much discussed fear about conflicts of interest when those being rated are paying for the privilege. Nobel Laureate George Stigler's concept of Regulatory Capture, where a regulatory agency created to act in the public interest instead acts in favor of the commercial or special interests that dominate the industry or sector it is charged with

regulating uncannily describes many of the issues facing regulators and agencies as they seek a way forwards.

Lawsuit

At the time of writing this article that position may be about to change, as a group of German investors prepare a class action lawsuit against Standard & Poor's over Lehman. This action follows US pension fund CalPERS recently winning a court ruling allowing it to proceed with a lawsuit, accusing the three biggest credit rating agencies of assigning "wildly inaccurate and unreasonably high" ratings, causing USD 1 billion of losses.

As it stands, the EU's first major foray will be unlikely to impact on balance sheet lenders or on other parties to public deals such as trustees or servicers, but it is likely to affect any lender engaged in commercial or residential mortgage-backed securities in the future, even those used for Repo transactions.

ESMA

The new European supervisory authority – the European Securities and Markets Authority (ESMA) – will have exclusive supervision powers over credit rating agencies (CRAs) registered in the EU. Broadly speaking, the first major additional power the EU Commission has proposed is overseeing a similar disclosure regime to that which exists in the US - SEC Rule 17g-5.

The Securities and Exchange Commission (SEC) rule prohibits rating agencies, termed NRSROs in the US, from issuing or maintaining credit ratings on certain structured finance products unless information that is provided to them, either by the securitisation issuer or the arranger, is accessible to all rating agencies. The purpose of the SEC rule is to promote unsolicited ratings on issuance and to facilitate ongoing monitoring by the rating agencies, which have published unsolicited ratings and ratings paid for by subscribers.

In essence the EU has adopted the same model with its primary objectives being: to avoid possible conflicts of interest arising from the issuer-pays model; to enhance transparency; and to increase competition among the rating agencies.

As per the SEC model, all rating agencies, the rated party and related entities will have access to all information that has been provided by the rated party for the purpose of its rating.

The real question is where do we go from here? My personal view is that any system that provides accountable transparency has to be good news. By providing properly controlled universal access any inconsistencies in rating agency ratings should be quickly recognised and examined. Handled correctly it should also allow greater scrutiny by independent bodies looking to perform their own diligence and this may just help pull the teeth from the argument for a yet more powerful EU super regulator which, in all probability, would just add a further layer of bureaucracy to the whole process.

Stewart Hotston is director of compliance and reporting at Hatfield Philips

<http://www.mfgonline.co.uk/article/Super-rating-agency-230205.html>