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Non-profit credit rating agency will assess sovereign risks and introduce competition

Quotes from RMI Director, Prof. Duan Jin-Chuan

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A not-for-profit credit rating agency that specialises in sovereign risk ratings could revolutionalise the financial services sector if it garners sufficient support from politicians, financial institutions and investors. Bertelsmann Foundation, the North American arm of Bertelsmann Stiftung, a German non-profit foundation dedicated to social change, has proposed the establishment of International Non-Profit Credit Rating Agency (INCRA).

In the blueprint for INCRA released in April this year, the Foundation set out the fundamental role of credit rating agencies as one that answers investors' questions on the probability of default by any sovereigns, i.e., "the likelihood that [investors] will receive all principal and interest payments scheduled for a given security". The blueprint, however, questioned "the acceptance, transparency and legitimacy" of the sovereign downgrades on a number of European countries last year by the three credit rating agencies — Moody's, Standard & Poor's (S&P) and Fitch — a move which it said immediately increased the borrowing costs of those states.

"On a broader basis, sovereign ratings that are relevant to contractual and regulatory provisions can have a mechanical, pro-cyclical effect, if such provisions result in the forced selling of securities," the blueprint further stated.

Annette Heuser, executive director of Bertelsmann Foundation in Washington and one of the key people involved in the INCRA initiative, said last year's ratings downgrade of some European countries demonstrated the immeasurable impact of credit-rating agencies on the market and the important status conferred upon them by the global financial services sector. "While the credit rating agencies did not ask for a 'systemic' status, it was given to them by the regulators," she said.

Highest asset class

Heuser said the Foundation has proposed that INCRA focus on providing sovereign ratings because it is the highest asset class, with around $7 trillion currently being allocated in the sovereign risk market worldwide. She said that because every asset class is dependent on sovereign ratings, sovereign risks rated poorly will also have a negative effect on their banking and corporate sectors.

"Unfortunately, [sovereign risk] is also the asset class that has been handled in an unprofessional way in the way that it has been rated. Credit rating agencies do not put a lot of top-rate analysts on rating sovereign risks, and they don't spend the amount of time and knowledge needed to do a comprehensive analysis. The reason being sovereign ratings are not [credit rating agencies'] main source of revenue; they make the bulk of their revenue from the corporate sector. Carrying out sovereign ratings is [nonetheless] priceless PR for the rating agencies. When they rate the sovereign risk of any countries, they have to take into account their banking sector," she told Thomson Reuters.

Breaking the oligopoly

Heuser said the Foundation aims to provide solutions to the challenges the financial sector faces and, in particular, the development of a new rating model was imperative. She said the Foundation's view and its proposal to set up INCRA has also resonated well with industry figures, including Moody's former head of sovereign ratings and a senior banker from Deutsche Bank, amongst others, and they agreed that it was time to call for a reform of the rating sector and the break up of the three-agency oligopoly. "The Foundation does not propose to shut down the three credit rating agencies, but rather to introduce a new player that is truly public and independent," she said.

The INCRA blueprint said Moody's, S&P and Fitch collectively account for about 95 percent of the market. The highly complex and cost-intensive business model of credit rating agencies, coupled with the cost of new regulations has made the barriers to entry prohibitive to new or smaller agencies, it said. "An Indian rating agency, for instance, can never get [this kind of] international recognition. There need to be international efforts to build an institution that is truly independent and will be well respected by the major financial institutions, as well as investors who have a great interest in high-quality sovereign ratings," Heuser said.

An international effort

Heuser said every market, from Europe and the U.S. to emerging markets such as Asia and Latin America, should concern itself with credit rating agency issues. "It is not just something that concerns only Europe or the U.S. Asia and Latin America would want to have a share of their say too. Emerging markets such as China and Brazil are expected to increase their borrowings; they would be concerned about having a reliable framework to analyse their sovereign risks," she told Thomson Reuters.

While changing the mindset of financial institutions and investors that have long depended on the three agencies is no overnight task, Heuser said, the G20 would have to show its support for INCRA by making the first move. The Foundation has begun talks with politicians, banks, insurance companies and sovereign wealth funds, all of which have expressed an interest in seeing the quality of sovereign ratings improve.

A roadshow is planned to start in Brussels this June, followed by Berlin in September and Rio de Janeiro in October. A conference will also be held in Beijing this year but the date has yet to be set. Heuser said the Foundation was working on a roll-out for Asia and would approach the region's regulators after the summer break.

She said the waves of regulatory reforms, from the European Securities and Markets Authority's (ESMA) regulations to the U.S. Dodd-Frank Act and changes in Asia, called for consistency in how credit rating agencies should operate. "What we have [right now] is a regulatory mess when it comes to credit rating agencies regulations worldwide … There is a lack of coherence for credit rating agencies to operate on a joint standard. To improve the sector we need to have a standardised code of conduct for credit rating agencies — the minimum standards, transparency and accountability expected of them," she said.

Public good

The INCRA model will be based on two pillars: governance and new indicators that the three credit rating agencies do not use in their analyses. Heuser said the new indicators are largely macroeconomic and forward-looking, and will offer a holistic analysis, although there would still be an element of human judgment. "Ratings can't be entirely objective even with our model, because you have people judging the indicators and then forming an opinion," she added.

Heuser said it could take three to five years for INCRA to produce high-quality ratings, and investors would want to see that INCRA is able to provide them with valuable information that they cannot find elsewhere before they are able to trust it.

Professor Duan Jin-Chuan, director at Singapore's Risk Management Institute (RMI), said initiatives like INCRA, which aim to benefit the public, should be encouraged. Duan is also the main driver of a public-good credit rating agency, launched in July 2009 that provides credit ratings solely on corporates, based on a quantitative model.

Although INCRA is at the proposal stage and its establishment could take some time, Duan said it was a significant development that could "really shake up the world". He said, however, that the three credit rating agencies would not disappear, given their entrenched status in the global financial market. "While there may already be some form of competition between them, it's a distorted kind of competition. They have to be confined to healthy competition with the introduction of public rating agencies that are truly independent," he told Thomson Reuters.

While it remains to be seen how RMI and INCRA might collaborate, Duan said the two organisations would have to join forces.