



FINANCIAL MARKETS, INDEPENDENCE AND REGULATION: THE CREDIT RATING AGENCIES

Donato Masciandaro
Dept. of Economics, Bocconi
University and SUERF

Disclaimer: The views expressed in this presentation may
only be attributed to his author in a personal capacity

1



Motivation

- The Credit Rating Agencies (CRAs)
- 1) What is the Purpose of independence?
- 2) What Role for Regulation?
- 3) How to Evaluate the EU Regulation?
- Disclaimer
- Background Paper:
- What If Credit Rating Agencies Were Downgraded? Ratings, Sovereign Debt and Financial Market Volatility, *Intereconomics*, 2011.

2

What is the purpose of CRAs independence?

- CRAs as efficient device in financial markets
- Financial Market Failures = asymmetric information between bond issuers and investors
- CRAs = supply of true news = price discovery
- Price discovery as price volatility driver = efficient chain

3

True News and CRAs independence

- Drivers of true news:
 - 1) insider information
 - 2) superior (human and technological) capital
 - 3) independence

4

CRAs and Regulation before the Crisis

- Notwithstanding:
- Market Structure = (Natural) Oligopoly
- Regulators considered CRAs as market discipline device
- Two main features:
- CRA Regulation = Light Touch Regulation (LTR)
- Overall Financial Regulation = f (CRA Ratings)

5

CRAs after the Crisis

- Question: Are CRAs suppliers of true news?
- Critiques:
- 1) no insider information
- 2) no superior (human and technological) capital
- 3) no independence = conflicts of interest (fees from issuers, cross selling, capture in governance)

6

Puzzle



- The more the Critiques are Robust, the more the CRAs are likely to be suppliers of false news.
- But then: How to explain price volatility?
- Explanation:
- Regulatory Failure: Certification Effect

7

CRAs Externality



- Volatility and Certification Effect = inefficient chain = externality
- Drivers:
- Regulation (exogenous) and CRAs communication policy (endogenous)

8

What Role for Regulation?

- Reforming Regulation:
- First Goal: CRAs going private, eliminating the certification effect
- Second Goal: CRAs going independence, eliminating fees from issuers
- Third Goal: CRAs going neutral, regulating communication policy

9

How To Evaluate the EU Regulation?

- Wrong Approach: Public Evaluation of Private Views
- Main Consequence: Hyper Certification Effect!
- The EU Regulation completely missed the point, mixing the risks of both market and regulatory failures

10

Why?



- Political Economy Story:
- Distortions in interest alignment
- The Certification Effect is convenient for:
 - Issuers
 - Investors
 - Regulators

11

Conclusion



- Please don't shoot the CRAs!

12