67TH SESSION OF THE GENERAL ASSEMBLY OF THE UNITED NATIONS

Thematic Debate on the Role of Credit Rating Agencies in the International Financial System

Comments by Chair of Panel Discussion, Dr Angus Armstrong

Excellencies, ladies and gentlemen.

May I start by congratulating the President, His Excellency Mr Vuk Jeremic, and the UN secretariat for prioritising International Finance. The International Financial Crisis - and its aftermath – is an entirely man-made catastrophe – it has added around 30mn people to unemployment world-wide.

While it originated in the biggest institutions in the richest countries - as the UN informs us - it has affected some of the poorest parts of the world. It is entirely appropriate, that all aspects of the international financial system are openly reviewed – without pre-judgements or vested interests.

Anyone who believes that history at least rhymes, even if not repeats itself, will understand the importance of having a truly consensual response.

Today we have an opportunity to engage with a panel of experts about one part of the international financial system – to discuss the Issues and Challenges Facing the Credit Ratings Industry.

Housekeeping

Before we start, some brief housekeeping rules. Following my remarks, I am going to ask each expert to give us their thoughts on the biggest issues and challenges facing the industry.

I will then allow an initial round of responses and clarifications. That will leave us around 40 minutes for questions from the floor – so please be prepared with questions you want to raise or statements you wish to make.

Comments

Ladies and gentlemen

Rating agencies have, of course, long played a central role in finance. For over a century they have acted as an important information intermediary

By giving an opinion about default, they also solving an asymmetry of information between borrowers - who naturally know better about the likelihood of repayment or default - and lenders or investors.

This supports financial intermediation which enables more investment and more economic growth. Not surprisingly, many countries today - including my own - are trying to replicate this model to promote lending to Small and Medium Enterprises. In fact, distinguishing the credit quality of borrowers is an absolutely vital ingredient for a sustainable economic recovery – and it is usually very unwise to cut-off the hand that feeds us.

However, to solve an asymmetry of information problem requires the intermediary to act in the interests of the uninformed agent – to reassure them - otherwise they can compound the problem. No good can come of the intermediary acting on behalf of the informed agent. An important question then is how and why over the last 30 years there has been a gradual shift from a “subscribers pay” or "investor pays" model to an “issuers pay” model of fee income?

If there is one thing that we have learned from this crisis it is that people certainly respond to incentives – and when rewards are not aligned with those exposed to the risks - we know what happens next.

But this simple story raises interesting questions. First, what led to the change in fee income model to an "issuers pay" model? One possibility is that it was connected to the increasing use of securitisation and a new source of profits from traditional old loan books.

- A benign view is that issuers sought to capture some economies of scale with so many securities requiring rating.
- A more malignant view is that the agencies were paid by issuers to provide some consultation with a view to improving the ratings.

Second, why were rating agents prepared to risk their hard earned reputation?

- One possibility is that reputation or franchise values plays a much smaller role in finance today - but more competition would simply erode this even further.

- Alternatively, the rating agencies are so entrenched by their networks - they certainly do not seem to have suffered - that we need much more competition not less

Third, perhaps this was simply an enormous failure of the public sector rather than the private sector. The regulators are supposed to be guardians of our financial system. But in making bank regulations even more dependent on credit ratings they effectively delegated responsibility to the private sector.

The regulators are supposed to act in the interests of the uninformed agents - depositors and the public in the case of banks. Have we created the cardinal sin of separating those who pay for the losses from the regulators? Intermediaries must act in the interests of the uninformed agent – to reassure them - otherwise they can compound the problem

Fourth, perhaps this is part of an enormous regulatory failure? We handed over responsibility for the global financial infrastructure to ISDA, IOSCO, Central Counterparty Clearing Houses even Basle to some extent - are all run - or heavily influenced by - the very institutions they are supposed to regulate!

Ever since Gresham's Law in the 16th century - differences in information have driven out good money - perhaps we need regulators to re-gain control of the financial infrastructure - starting with looking at the income model for rating agencies. I hope that has at least stimulated some disagreement with our panellists and look forward to hearing from each in turn on their perspective of the Issus and Challenges facing the Credit Ratings Industry.

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