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Severing the institutional ties

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The list of the alleged guilty parties responsible for the financial crisis is long. With growing frequency the ratings agencies are also coming under fire. Solutions vary from stronger regulation to the establishment of a "European" rating agency. However, all of these solutions are aiming in the wrong direction. It is necessary to sever the institutional ties of the rating agencies. What is needed is to reconnect action and liability of financial market participants. The evaluation of risks and the responsibility for the resulting losses must be located with the relevant actors.

Rating agencies under criticism

The list of the alleged guilty parties responsible for the financial crisis is long: starting with individual companies, to entire sectors of the economy, all the way to capitalism as such – in regular intervals, depending on how the political winds are blowing, there are public tribunals. And with growing frequency the ratings agencies are also coming under fire. Recently, the head of France's central bank, Christian Noyer, summed up his verdict on the ratings agencies by declaring that their conduct was "incomprehensible and irrational." It may very well be that this assessment was influenced by the recent downgrade of France's rating.

Rating agencies unable to identify trend changes

What, then, is the service provided by a rating agency? The goal is to offer a metric to assess the probabilities of a default. Although those probabilities are supposed to be forward-looking, in actuality to a large extent they reflect past data. Since ratings are supposed to be derived "over-the-cycle" – meaning: without taking into account the more short-term cyclical movements – ratings only provide a statement about an existing trend. Accordingly, rating agencies are almost by definition unable to identify a trend change. In the final analysis they also describe merely what other publicly available data have already indicated.

Different points of critique

However, criticism of the rating agencies is only in part based on these systemic factors, namely that ratings changes often come too late and are then very pronounced, especially in cases of downgrades. In this way, rating agencies often intensify downtrends in the markets. These arguments are repeatedly put forth also in connection with the sovereign debt crisis in the euro zone. As a result there are already proposals to prohibit ratings downgrades. In addition, methodological errors and inaccurate modeling of risks are often criticized.

A cornucopia of proposed solutions

The palette of solutions to these problems is richly varied: from Brussels come proposals for a stronger regulation of the ratings agencies, for example greater transparency of the ratings methodology or a rotating system of analysts. Floating around on the general European stage is the idea of a "European" rating agency as a way of once-and-for all escaping what is supposedly the environment of the US-rating agencies dominated by special interests.

Solutions are aiming in the wrong direction

However, all of these solutions are aiming in the wrong direction, for even stronger regulations or another rating agency will not eliminate the causes. After all, the existing rating agencies hold this dominant position not because they are in fact able to predict the future with 100 percent accuracy, but because their analysis – while only one opinion among many – has been declared as the comprehensive truth by government regulation. In the wake of a downgrade, funds usually do not sell securities because they share the opinion of the agency, but because the downgrade might mean that they are longer legally permitted to own these securities. Thus the result is a regulation-induced self-fulfilling prophecy. If ratings agencies were prohibited from issuing downgrades, that would lead to restrictions on freedom of speech. The rating agencies should be allowed to voice their opinions, but one should not force an entire sector to act in response to them.

The principle of liability

The solution to this problem is therefore quite simple: the institutional ties of the rating agencies must be severed. But we cannot do without an evaluation of the outlook. Here it would make sense to fall back on one of the seven principles that constitute a competitive system according to the German economist Walter Eucken: the principle of liability. Those who act must be held accountable for their actions. This principle was weakened with the outsourcing of risks to the rating agencies. This contributes substantially to the existing problems. What is needed, therefore, is to reconnect action and liability. The evaluation of risks and the responsibility for the resulting losses must be located with the relevant actors.

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