German banks have had enough of Standard and Poor's and other agencies, and they're not going to take it any more.

Das Empire Strikes Back

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For more than a decade, bankers, industry executives and politicians on the Continent have complained about Europe's humiliating dependence on the almighty U.S.-regulated rating oligopoly. Now, the revolt against America's unchecked rating power is pressuring politicians to push the European Union towards regulating the global rating trio. There is a groundswell of support for establishing a European rating agency. But all this is easier said than done.

As European companies move from borrowing money from their banks to tapping the world's capital markets directly—by issuing bonds, medium-term notes, or commercial paper—their securities need to be rated. But there is a problem: Europe doesn't have a major rating agency that would take into account the special characteristics of European accounting or the prevailing differences in financial ratios as they evolved in a bank-based financial system.

Finally, this problem is becoming political. Proposals by the European Parliament's Committee on Economic and Monetary Affairs to establish a European Registration Authority for rating agencies under the auspices of the Committee of European Securities Regulators (CESR) may be far ahead of the curve. They point to "a European nightmare—that unchecked American rating agencies become the Continent's boss men." EU parliamentarians are looking for ways to contain American rating power by putting global rating giants like Standard & Poor's, Moody's, and Fitch under some kind of new EU regulation. So far the Brussels Commission—with the British government keeping a watchful eye on the stakes for Lon-

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European Missed Opportunity

Almost ten years ago this observer of the financial scene wrote about several initiatives to establish a European-wide rating agency. (See *The International Economy,* November/December 1994.) Unfortunately the French investment company Centenaire Blanzy, which held a majority stake in IBCA Group (which later merged into Fitch), could not come to terms with Bertelsmann, Germany's large publishing conglomerate.

Having a large publishing concern as a parent was considered to be a structure under which S&P—a subsidiary of McGraw-Hill—maintained a position of independence and credibility.

The Bertelsmann setback followed an earlier failure of a much-heralded effort by Germany's powers in finance and industry—including nine top banks and nine big industrial groups—to form a European-wide rating agency under German leadership. Together with a Frankfurt publishing house, they formed a project company in April 1991, but their efforts dissolved in the middle of 1993. Leading the drive for Europe as a "third player" were Rolf E. Breuer, who later became chief executive and chairman of Deutsche Bank, and rating projects manager Oliver Everling. "Those who supported our project to establish a European rating company saw Europe's total dependency on America's rating monopoly coming," comments Everling, who now publishes a rating newsletter. "To the ThyssenKrupps, the Munich Res, the Landesbanks, or other debt issuers complaining about unfavorable ratings," says Everling, "I can only say: I told you then. It was a missed chance for Europe, that never comes back that way."

—K. Engelen

don as a global financial center—is playing for time. But the German government, faced with a domestic revolt against damaging rating decisions by Standard & Poor's, is under mounting pressure to control what is perceived as an excessive level of American rating power.

Because the completion of the EU single market in financial services requires an appropriate framework of financial market regulation, a question fraught political and financial dynamite arises: Can Europe accept that the debt instruments issued in its expanding European capital markets are only regulated by a U.S. securities supervisor, the Securities and Exchange Commission?

This is today's reality. More than a decade ago the Europeans missed their chance to establish a major rating agency more attuned to the bank-based financial systems prevailing in Europe rather than the capital market-based financial system and the highly developed equity culture of the United States.

How financial intermediation differs in the financial systems of Germany and the United States has important implications for the role and the focus of ratings. As the International Monetary Fund stated in

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its recent "Financial System Stability Assessment for Germany," the banking sector still accounts for approximately 78 percent of the German financial system's gross total assets. Most companies still rely on bank loans even though the share of securitizations in intermediation flows is expanding rapidly. This com-

The Rating Agencies: "Irresponsible, unprofessional… uncontrolled world powers."

According to **Edgar Meister,** *the Bundesbank's banking supervisor: "These notional ratings are not particularly appropriate for evaluating a situation that won't be here until 2005. We should grant the Landesbanks time to adapt and implement their strategies. Publishing such ratings could make this more difficult."*

Jochen Sanio, *Germany's chief financial supervisor, sees today's major rating agencies as "uncontrolled world powers that are directing global capital flows by appraising the credit standing of debtors." And he warns: "Until now rating agencies have been able to operate without being forced to adhere to generally recognized or binding principals. This cannot go on."*

Karl-Heinz Boos, *executive managing director of the Bundesverband Öffentlicher Banken Deutschlands, argues: To issue notional ratings at this time when most Landesbanks are in the process of adjusting their capital base and business plans is "irresponsible and unprofessional."*

pares with a U.S. financial system where banks only represent around 20 percent of gross total assets.

This explains why historically it was the U.S. financial system where the need for rating agencies first arose. Based on 2001 numbers—presented in Congressional hearings on the role of the major rating agencies following the Enron debacle—the three globally dominant rating concerns reach a market share of 95 percent. Only Standard & Poor's, owned by the McGraw-Hill Companies (42 percent); Moody's (38 percent); and Fitch, owned by European investors (14 percent); together with the first newcomer in ten years, Dominion Bond Rating Service, are registered by their supervisor, the Securities and Exchange Commission, as "Nationally Recognized Statistical Rating Organizations" to do business in the globally dominant U.S. capital markets.

Recent German anger about how Standard & Poor's jolted the embattled state bank sector by trying to put forward fictitious ratings is putting pressure on politicians, financial supervisors, and the Berlin government. The way the world's largest rating agency has been downgrading major German companies such as ThyssenKrupp to junk status because it changed the treatment of pension obligations in the rating process was another jolt. Due to S&P's recent rating actions, the decade-long tensions between embattled "Germany, Inc." and its global raters are reaching a breaking point.

By announcing, on November 13, 2003, that it would come up, by November 24, with downgrades on unguaranteed Landesbank obligations, Standard & Poor's was set to deal a fatal blow to an important sector of Germany's banking system, the Landesbanks. This is why. Under an agreement with the EU Commission in Brussels, eleven Landesbanks must phase out state guarantees by July 18, 2005. This is considered an important step toward securing a level playing field in European financial markets. The Landesbank guarantees have supported top-notch credit ratings, which in turn meant cheap funding. Critics charged that by publishing Landesbank ratings on the basis of unguaranteed obligations immediately, i.e., long before the phase-out of state guarantees in 2005, Standard & Poor's was unsettling the difficult phase-out process. Indications from the "unguaranteed debt" ratings that were leaked following the announcement on No-

vember 13 suggested that all but three Landesbanks would be allocated ratings in the BBB- range, compared with the AA and AAA ratings they currently receive. What a blow.

To large segments of Germany's political and financial establishment, Standard & Poor's rating action amounted to a declaration of war. It was noted in German official and business circles that Moody's, the other major U.S. rating agency, distanced itself from Standard & Poor's bombshell. Juergen Berblinger, managing director of German operations for Moody's (who left at the end of 2003), indirectly criticized his competitor's rating action by stating: "In our view it is inappropriate and premature to publish unguaranteed ratings." He was supported by Moody's veteran European bank analyst Samuel Theodore, who sharply criticized Standard & Poor's move toward publishing notional ratings. Fitch, the smaller rater, first kept its powder dry by signaling that it would only put out ratings on an unguaranteed basis in case the Standard & Poor's went ahead with their announced notional ratings. When it became clear that Standard & Poor's had reversed itself and announced that it would publish their unguaranteed ratings about half a year later, Jens Schmidt-Bürgel, head of Fitch in Germany, followed suit by telling the press, "It's clearly the wrong time to publish such ratings."

There was unprecedented political pressure exerted by the German government, financial supervisors at BaFin (the German Financial Supervisory Authority), and the Bundesbank on Standard & Poor's not to publish those "notional" or "fictitious" ratings. They argued that it was much too early to do this. Parallel ratings would unsettle the difficult transition process between now and the middle of 2005. Such ratings would not adequately take into account the fact that all obligations issued by Landesbanks expiring before 2015 would be covered under the state guarantees.

As was to be expected, German banking associations representing the Landesbanks and their main shareholders, the Sparkassen, mounted a fierce counter-offensive. Argues Karl-Heinz Boos, executive managing director of the Bundesverband Öffentlicher Banken Deutschlands (VÖB): To issue notional ratings at this time when most Landesbanks are in the process of adjusting their capital base and business plans is "irresponsible and unprofessional." High officials in the Berlin finance ministry reacted angrily: Should Standard & Poor's issue parallel ratings (with and without guarantees), this would mean that the lower ratings would stick to obligations even if these were covered by state guarantees—which damages the issuing bank. Edgar Meister, the Bundesbank's banking supervisor, told a press conference: "These notional ratings are not particularly appropriate for evaluating a situation that won't be here until 2005. We should grant the Landesbanks time to adapt and implement their strategies. Publishing such ratings could make this more difficult."

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And Jochen Sanio, Germany's chief financial supervisor, told *Handelsblatt*, Germany's business and financial daily, that he "cannot see any valid arguments that Standard & Poor's could put forward to justify fictitious ratings for Landesbanks at this time." Sanio sees today's major rating agencies as "uncontrolled world powers that are directing global capital flows

Gave in to heavy political pressure: **Torsten Hinrichs,** *head of Standard & Poor's in Germany, gave the state banks a year more of breathing space.*

by appraising the credit standing of debtors." And pointing to the bitter fight of German corporations against Standard & Poor's downgrades because of differences in accounting for pension liabilities, Sanio warns: "It is simply not acceptable that corporations have no way to defend themselves in important accounting disputes by appealing to an independent authority." Therefore, Sanio argues, " European corporations should think seriously again of supporting a European rating agency that in its initial phase could get additional credibility by putting itself under a financial supervisory agency." And he warns: "Until now rating agencies have been able to operate without being forced to adhere to generally recognized or binding principals. This cannot go on." Although rating agencies have not been brought under financial supervision so far, one should expect that they adhere to the highest ethical standards, says Sanio.

Bad experiences with the Anglo-Saxon–oriented raters have built up resentments among companies and financial institutions on the Continent.

For Germany's political and financial establishment, the stakes in fending off Standard & Poor's provocative rating action were high. Kirsten Bremke, financial sector analyst for consulting firm A.T. Kearney, points to frightening numbers. "The average of the Standard & Poor's predicted ratings which have now been predicted comes out slightly below A-. After a transition period, these ratings mean that German state banks would face additional annual refinancing costs of about €4–5 billion." Bremke adds: "Following the loss of the public guarantees in mid-2005, the German state bank sector faces significant challenges and several new concepts have already been developed." New types of guarantee mechanisms could eventually help to mitigate the rating deterioration but will not prevent it, she argues. "In order to avoid losses, state banks also need to further focus on leveraging their core competencies and effectively implementing and communicating their strategies. New and creative ways of cooperation will play a key role going forward. We see three main levers: making better use of the synergies between state and savings banks in order to reduce costs, for instance by way of transaction factories; improving risk management quality and standards; and portfolio diversification effects by pooling credit risks in order to free capital for profitable growth."

When an empire strikes back, there are winners and losers. On November 24, Standard & Poor's had to scrap plans for the highly contested rating downgrades of the country's public sector banks in a move, says the *Financial Times,* "that sent worrying signals to investors." Without giving names, the *Financial Times* quoted prominent bankers at Germany's Landesbanks warning that "political attempts to influence rating agencies' plans for the sector could be catastrophic for the country's reputation in financial markets." The paper quoted another banker from the state bank sector: "There are only losers in this, as far as reputations go: Standard & Poor's has egg on its face and we are left with uncertainty hanging over us."

Giving in to heavy political pressure, Torsten Hinrichs, head of S&P in Germany, gave the state banks a year more of breathing space. He came out with a statement that, "Standard & Poor's has decided not to publish the preliminary ratings on individual banks at this point in time because the Landesbanks are still in the process of determining and developing their structures, strategies, and plans to cope with a new environment after the loss of state guarantees in July 2005." Instead, Standard & Poor's will publish the ratings on the Landesbanks' unguaranteed obligations in July 2004, one year prior to the loss of the state guarantees, on which the current ratings are based.

"Standard & Poor's has reached this decision based on the fact that many of the banks' plans are still a 'work in progress', involving fundamental decisions regarding the banks' future business models, restructuring plans, closer cooperation with the savings banks, intra-group support mechanisms, and ownership structures," says credit analyst Michael Zlotnik. But Standard & Poor's made sure to get the eleven Landesbanks working on their stand-alone ratings by announcing that "following the completion of its review of the preliminary ratings on the unguaranteed obligations of German Landesbanks … it has deter-

mined that the ratings on such obligations from today's perspective would range from A+ to BBB." This raises the obvious question: Didn't they know this all before?

However, in the view of Achim Duebel, a veteran World Bank financial sector expert, an argument can be made in favor of stand-alone ratings. When, in 2000, Fannie Mae and Freddie Mac agreed with the U.S. Congress to solicit such stand-alone ratings, this resulted in greater transparency of the implicit guarantee given by U.S. taxpayers to these institutions. Similarly, German taxpayers are entitled to see the dimensions of support they are giving through the guarantees to the Landesbank sector. By looking at the difference between the two ratings—with and without the guarantee—the cost of the guarantee can be quantified. In the case of Fannie Mae and Freddie Mac, the stand-alone rating action had no noticeable impact on the spreads of the debt they issued.

But there are less spectacular ways that German debt issuers—bruised by what they consider totally unjustified downgrades—are fighting back. Long before Standard & Poor's nearly dealt a fatal blow to the Landesbanks, it clashed with several leading German companies such as steelmaker ThyssenKrupp and insurance giant Munich Re over highly controversial downgrades. In mid-February 2003, Standard & Poor's downgraded ThyssenKrupp to "junk" status, despite solid first-quarter results and a renewed commitment to triple profits to €1.5 billion in two years. This stunning rating action came on the heels of an earlier warning by the rating agency of its intent to cut ThyssenKrupp's ratings by up to two notches

Should Europe's economy remain what some call a "rating colony"?

due to its "unfunded pension liabilities." ThyssenKrupp has €7.1 billion in pension provisions and pays about €450 million annually to service its pension obligations. In reacting to the damaging downgrade, the company stressed that "it saw no reason for a downgrade since its pension obligations had not changed significantly." The company estimated an increase in funding costs for short-term financing of €20 million thanks to Standard & Poor's actions.

To make its point, ThyssenKrupp, Deutsche Post AG, and Linde AG commissioned two respected academic professors, Prof. Dr. Wolfgang Gerke of Erlangen-University and Prof. Dr. Bernhard Pellens of Ruhr University-Bochum, to do a research report on pension provisions, pension funds and the rating of companies, which concluded that ThyssenKrupp was using the common method in the German system, "where the necessary assets are built up successively in the

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company during the service period of the employees and where the pension provisions stated on the liability side of the balance sheet show the amount of the pension obligation." In a sudden change of the rating process, the academics argue, "Standard & Poor's had opted to use only a second method, which is widespread in the Anglo-Saxon countries and therefore also in the United States, where the company pays regularly into a pension fund." The pension fund invests the money in various capital investments. The assets required for the pensions are accumulated outside of the company. Pension provisions are only shown in the company's balance sheet if the plan assets do not cover the pension obligation, if there is a deficit." The ThyssenKrupp controversy over their pension accounting is a good example of how differences in accounting methods are putting European debt issuers at a disadvantage with rating agencies," says Pellens.

Bad experiences with the Anglo-Saxon–oriented raters have built up resentments among companies and financial institutions on the Continent. Some in the second and third tiers of bank and company management still criticize openly the "display of colonial attitudes of raters" and their unwillingness to take into account the special characteristics in European accounting, disclosure, and management practices." So it doesn't come as a surprise that in the case of Standard and Poor's, relations with corporate and banking clients in Germany have deteriorated so much that the

agency found it necessary to host a goodwill dinner to mend soured relations with Europe's largest financial sector.

As in the turbulent negotiating process towards the new Basel accord for bank capital (Basel II)—where Germany's small- and medium-sized firms are afraid of losing their sources of finance—grassroots pressures are building on the German government and the members of the Bundestag to rein in America's rating power over Europe's economy. Responding to those pressures, last summer the Berlin finance ministry asked major German industry and banking associations to assess the role of rating agencies.

Reinhard Kudiss, economist for the Federation of German Industries (BDI), argues in a position paper on rating agency activities for strengthening the independence of the European capital market: uniform minimum requirements of methodology, procedure, and diligence should be established at least on a European scale. Such requirements should be tied to mandatory registration under suitable European authority. And he continues: "Independence can be further reinforced by setting up a European rating agency, which could ensure that particularities of European companies are given greater consideration." A rating agency that would add value in this way "is sure to find recognition among investors and issuers." And he adds: "We should aim for this agency to be recognized by the SEC on the basis of securing a level playing field."

Today's discussion on rating agencies, argues the BDI paper, is prompted by several partially unconnected factors including monumental bankruptcies (Enron, WorldCom, etc.), a high proportion of downgradings in the producing and banking sectors, changes in rating methodology (treating pension reserves as financial debt), and the review of the credit rating of the Federal Republic of Germany. Seen in isolation, these occurrences only permit limited conclusions to be drawn on the weaknesses in the work of rating agencies. However, there certainly are weak points in current rating practices that must be eliminated. Says Kudiss: "One of our main points of criticism is the lack of transparency and supervision of the rating procedure." Although only few cases have been observed where abuse (ranging from indiscretion and errata up to deliberately incorrect decisions and political interest) and/or procedural errors occurred in an assessment, the issuing companies have no possibility of rectifying the situation.

The umbrella organization of Germany's banking association (Zentrale Kreditausschuss, or ZKA) has asked the German government to push for an international regulation of rating agencies with an eye towards minimum requirements for harmonization. In this effort Germany should build on recent work done by the SEC. Pointing to the 95 percent market share of the three rating agencies, the ZKA warns European financial supervisors, government officials, and legislators to stop linking more and more regulation to ratings thereby further increasing the dominance of the U.S.-regulated rating duopoly.

And as in the case of spelling out minimum requirements for negotiating Basel II, the German Bundestag's Finance Committee has been actively debating the regulation of rating agencies. On October 14, 2003, opposition members of the Bundestag asked the German government to respond to a list of questions with respect to regulating rating agencies. Some of the questions reflect the widespread concerns about the impact of rating decisions on the funding of corporations and financial institutions.

What is the German government doing about regulating rating agencies, improving transparency of the rating process, and getting rid of the rating industry's oligopolistic structure? According to the ministry's finance secretary, Karl Diller, Berlin is looking for answers to such questions by talking to the United States and working together on such issues in international expert groupings such as the International Organization of Securities Commissions and the Financial Stability Forum. Germany anticipates rules for rating agencies in the United States: this would mean among other things that the SEC would recognize further rating agencies as "nationally recognized statistical rating organizations."

On the Brussels stage, so far only the European Parliament is responding to the issue of whether Europe's economy should remain what some call a "rating colony." Giorgos Katiforis, as rapporteur of the European Parliament's Committee on Economic and Monetary Affairs, asks some pointed questions. "The issue confronting us is a political, not a technical one, more particularly it is an issue of regulation of the credit rating industry—a business sector which, until now, has virtually remained totally outside of the purview of regulatory authorities. Should there be regulation; if "yes" how far should it go; should it entail a specifically European aspect?"

He points out that today's major rating agencies have emerged "from the need to service the huge capital market based U.S. financial system by applying a

mechanism of checking the creditworthiness of those seeking to use other people's money in order to engage in business." But "in Europe for centuries this control activity used to be one of the functions of banks, which made a point of developing a personal relationship and trust with their clientele." In the United States, on the other hand, "with its vastness of territory and the pioneering practice of direct access to the public by borrowers through financial markets, personal contact between creditors and debtors was difficult to contemplate," argues Katiforis. "This gave rise to the need for a specialized agency that would collate all available information, reach an informed opinion regarding the riskiness of certain investments, and make it publicly known through the press."

In discharging over the years their commercial task as self-appointed watchdog over borrowing, rating agencies have by and large won the confidence of the investing public and have established for themselves solid reputations of success in more or less accurately predicting the probability of default in borrowing.

Why then should the issue of their regulation arise at all? The reasoning of the EU Parliament's committee will guide the future debate:

- **Because the structure of the ratings industry has grown heavily oligopolistic.** Globally, it is essentially duopolistic, consisting of Standard & Poor's and Moody's, both of American ownership and solid U.S. implementation.
- **Because as the leaders of this industry, these two companies are exercising enormous power over the markets.** It must be noticed here that the predominantly American character of the agencies and of their supervisors (the SEC, the U.S. Congress) creates a vast *de facto* imbalance toward the American side, an imbalance created not by design but capable, nevertheless, of upsetting the smooth operation of the markets.
- **Because, despite their on the whole quite respectable professional performance, rating agencies have suffered some spectacular reverses recently.** These include the totally unpredicted bankruptcies of Enron and WorldCom as well as with the Asian ratings crisis of 1997.
- **Because the agencies have become an essential part of the regulatory mechanism of financial markets.** Even though they themselves did not deliberately seek this role, high-grade ratings nonetheless have become a legal prerequisite for the eligibility of bonds for the portfolios of institutional and especially fiduciary investors (i.e., pension funds).
- **Because a number of potential conflicts of interest have emerged in the course of the agencies' normal professional activity.** Some examples are privileged access to inside information; earning the bulk of their income from fees paid by those assessed by them; and developing ancillary consultancy businesses related to the rating of specific clients. This last aspect of their work tends to assume ever larger proportions to the extent that increasingly complex forms of finance, such as the Collateralized Debt Obligations (securitization, etc.), take shape in modern markets.

This outline from the EU Parliament's committee is very much to the point, as is its conclusion that Basel II will enormously expand the use of external credit ratings. Basel II makes the amount of regulatory capital to be held by banks a function of the bank's assets, to which risk weights, as defined by credit ratings (as one way of determining such weights), are attached. This extension of the uses of credit ratings, warns the Committee's rapporteur, "disturbs the balance of the playing field between European and American banks, in favor of the latter." The questions remains whether the predominantly U.S.-oriented rating agencies have absorbed enough of the European business culture to be able to function without friction in the European environment.

Finally, there is one message from the EU Committee that is confirmed by most official participants in the discussion about rating agencies: That the debate in the United States and in Europe in various international groupings like the Financial Stability Forum, the International Association of Insurance Supervisors, or the International Organization of Securities Commissions "has veered in the direction that more rather than less regulation of rating agencies is to the point."

But as World Bank financial sector expert Achim Duebel points out, "The focus of European efforts at this stage should be on two issues: to make sure that the major rating agencies take more into account the structural and legal differences of the financial systems, and to see that Europe contributes toward improving the level of investor protection. An open question in this regard is whether rating agencies should not be paid by investors rather than issuers. Because of the recent monumental failures of the major rating agencies, European regulators are not in a bad position to ask for far-reaching reforms." ◆