

# Rebuilding Confidence in Credit

## Panel on Creating Sustainable Financial Systems in Europe

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I am here today to give you my perspective on some of the elements necessary for reintroducing confidence into the European credit markets. I recognise that this has many dimensions.

Most importantly, investors need reassurance regarding the sustainability of sovereigns' balance sheets and the solvency of the banks which hold their debt.

That is a hugely challenging task, and is beyond the scope of my remarks today. Instead, I want to focus on the regulators' efforts to reform the structure of the European credit markets.

### **1. We all agree that credit is important**

It is stating the obvious to note how important an effectively functioning credit market is right now.

Europe faces a huge challenge in generating the economic growth needed to recover lost capacity and to enable borrowers, including governments, to service debts accumulated during the years of moderation. The efficient flow of credit is an important driver of long-term growth and a key determinant of the amplitude of the business cycle.

Right now, credit markets are hindering, not supporting, growth. We see the evidence all around us – in stagnant lending to households and corporates, in the near-complete absence of private securitised lending, and in falls in issuance of corporate debt in Europe following a significant rise in 2009.

Regulators have responded by encouraging the banking sector to provide more credit. However, while that may help in the short run, it also risks encouraging the same problems of poor debtor differentiation we saw prior to the crisis. Sustainable long-term recovery will not be achieved unless the necessary conditions are in place for effective and efficient credit creation.

## **2. Credit market efficiency depends on confidence and the ability of lenders to make well-informed lending decisions**

One aspect of a reform agenda aimed at improving market efficiency should be to promote disclosure of comprehensive information by borrowers.

That is indeed recognised in some parts of the regulatory and market participant community – for example, in the ECB's initiative to promote transparency of credit-relevant information on securitised products.

However, not all see that as straightforward a proposition as I do.

One school of thought has it that greater access to information encourages greater volatility in the credit market. Just as the crisis reignited the debate over the impact on market volatility of accounting rules, which offer greater transparency of the value of banks' assets and liabilities, so some argue that greater disclosure by borrowers would be costly and potentially destabilising.

I profoundly disagree with that view.

Requiring more frequent, consistent and detailed disclosure of financial information by all issuers – in particular for structured products, and banks – would support efficient credit provision by improving lenders' access to the information needed to undertake effective credit assessment.

It should be a centre point of the reform programme.

I'll return to that theme shortly.

## **3. On the role that Credit Rating Agencies play in promoting efficient credit markets**

Regardless of how far-reaching the steps that regulators take over the coming months, imperfections will continue to impede the functioning of credit markets.

Information asymmetries mean that, even with fuller disclosure, borrowers know more about their finances than lenders, and have the incentive to present them as favourably as possible.

And the channelling of funds through intermediaries will continue to create principal/agent problems, with the savers challenged to ensure that fund managers' incentives are aligned with their own.

CRA's grew up in part to address those market imperfections. CRA's ability to devote time and resources to obtaining the necessary information allows them to collect and analyse information in a manner that promotes efficiency and helps contain investors' and borrowers' costs.

That role carries a certain amount of authority, and with authority comes responsibility and accountability. Moody's staff understand those responsibilities, and do not bear them lightly.

We have taken a number of steps to address the lessons we learned. And, in this respect, we also have embraced the regulatory changes introduced recently that reinforce the responsibility of credit rating agencies to the markets for the quality of their ratings, and increase CRA accountability to regulators for adhering to their processes.

#### 4. The importance of independence and diversity of opinions

I remain absolutely clear that our role as an objective and *independent* provider of credit ratings remains an important one for the effective functioning of the credit markets.

I emphasised the word "independent". CRAs serve no useful purpose if their views are not independent of the views of the market on the one hand, and of government officials, regulators and issuers on the other.

CRAs are often criticised by market practitioners for changing their ratings too slowly, and by issuers for moving too quickly. Both are criticisms we face robustly, since they generally result from offering an independent view of creditworthiness.

One key difference between market prices and credit ratings is that credit ratings seek to balance stability as well as accuracy of ratings, to capture enduring changes in credit risk rather than transient changes in market sentiment.

So they move at different paces – by design – in order to meet investors' needs for a balanced, medium-term view. One positive effect is that ratings can mute pro-cyclical market dynamics.

So, for example, the ratings of European sovereigns have declined more slowly than market prices. This was deliberate.

It reflected the gradual emergence of information relevant to long-term credit quality.

First, the policy framework, and the threat which that poses to investors in sovereign bonds, has developed slowly, and remains fluid.

Second, it is only gradually that we have seen the market dysfunction – which we would normally look through – become a long-term feature of the credit markets which we can no longer ignore.

Equally, we understand the need to withstand inappropriate influence from issuers. Much has been made of the conflict of interest inherent in the issuer-pays model. I can only repeat that conflicts of interest arise in any business model. What matters is how

those conflicts are managed. Moody's has controls and processes in place to achieve effective separation.

## 5. Let's finally turn to the current regulatory agenda in Europe

Independence is important, and investors are not well served by changes in regulation which limit it.

My concern is that some aspects of the evolving regulatory agenda – commonly referred to as 'CRA3' – introduced by Commissioner Barnier aim to achieve precisely that.

There is a great deal that regulators can do to improve the functioning of the credit markets. We have argued on many occasions that credit ratings should be part of a wider risk assessment toolkit, not the sole tool. Yet ratings continue to be used in a mechanistic way, which can cause extreme market dynamics.

One reason for this is the embedding of credit ratings in regulation. The Commission has suggested that steps will be taken to withdraw ratings from regulation. We would welcome that: indeed, we believe that ratings will be better used without such linkage.

Similarly, we welcome steps that promise to encourage financial intermediaries to undertake more of their own credit assessment. There is nothing – other than the cost – to prevent professionals from building up their resources so that they have both the *skills* and the *time* needed to undertake their own credit assessment.

In other important areas, however, we see less progress. Most importantly, there appears to be little progress to improve the *transparency* of European credit markets by requiring greater disclosure by borrowers. While we should not underestimate the complexity of designing a disclosure framework or the costs to issuers, the benefits to investors and the financial system would be material.

But my greatest concern is in relation to aspects of the regulatory agenda which seem designed to diminish CRAs' independence and usefulness to investors, by either constraining their ability to offer opinions or influencing those opinions.

Reports suggest for example that the Commission will grant the regulatory authorities considerable influence, not simply over the process used to develop rating methodologies, but over the content of those methodologies making the regulator the de facto standard setter of credit opinion.

In addition, we are told that the Commission plans to introduce a forced rotation of CRAs as well as powers to constrain or prevent CRAs from continuing to issue sovereign credit ratings in certain circumstances, proposals that will diminish investors ability to make informed credit judgments.

Such an interventionist approach to regulation would demand very clear justification.

The Commission appears to have concluded that, through their ratings actions and alleged conflicted business models, the CRAs have contributed to the loss of investor confidence in Europe.

And that competition from more CRAs, forced rotation and regulatory approval of methodologies will improve ratings quality, which in turn will improve confidence in the European market.

There is no basis for such a conclusion.

It is clear that the root cause of the loss in confidence is the uncertainties surrounding the resolution of sovereign debt crisis, and that the direct link is investor risk aversion which has run well ahead of rating changes.

Whatever the motivation, the proposed powers represent a material intrusion on CRAs' independence of view.

The efficiency of the European credit markets will inevitably be damaged by any policy which aims to deny investors access to informed, independent credit views. Neither the interests of investors nor the long-term growth prospects of European economies are well-served by such policies.

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