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The road to self-deception

A new EU plan to shoot the messenger

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We interrupt this column for a message from the European Commission. With Italy being advised by the International Monetary Fund, negative opinions about its bonds are not helpful. The publication of this article is not permitted.

Thankfully, the EU has not decided to censor *The Economist*. **But a European Commission draft paper on credit-rating agencies does propose that, in some circumstances, they should be barred from changing their sovereign ratings.**

Let us be clear what that means. A credit rating is an opinion about the likelihood that a borrower will repay its debts. The issuers of these opinions are largely based in America, a land where free speech is constitutionally guaranteed. (Fitch has dual headquarters in New York and London, although its majority-owner is a French investor.)

Even if the EU could get away with this censorship, what purpose would it really serve? At a crucial moment the agencies would have to declare that they were unable to provide a rating of the country, as clear a signal to the markets as a downgrade itself. The authorities are worried that a ratings downgrade might cause a downward spiral, making it more difficult to rescue an embattled sovereign. But there are other trigger points. To take one example, on November 9th a surge in Italian bond yields prompted demands from clearing-houses for more collateral from those using this debt as security.

The attitude of the commission also suggests a certain paranoia that European sovereign issuers are being treated unfairly by ratings agencies. The reverse is the case. French ten-year bonds trade on a yield more than a percentage point higher than their German equivalents, even though both share a AAA rating. An analysis by Exotix, a research group, found that peripheral European nations have ratings six notches higher than emerging economies with similar financial conditions.

The commission's paper is part of an ignoble tradition of "shooting the messenger". Other examples include curbs on short-selling and a determination to crack down on credit-default swaps, a form of insurance against default.

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The ratings agencies have their flaws. They failed badly in the subprime boom and the big three outfits—Moody's, Standard & Poor's and Fitch—have a dominant market position. But where the draft paper tries to deal with competition, it goes about it in a cack-handed manner. Take the proposal to force the rotation of ratings agencies, which could lead to big debt issuers changing their provider every year. Since many issuers are rated by more than one agency, this would lead to phenomenal turnover. The principle of "Buggins's turn" would mean agencies would not really be competing at all. The Association of Corporate Treasurers, which represents borrowers, worries that forced rotation of agencies would lower the quality of the analysis.

Then there is the crazy idea that agencies cannot rate securities in which their leading shareholders have an interest. That would mean, presumably, that Moody's could not rate any of the bonds owned by the companies in the Berkshire Hathaway group, its leading shareholder. Every time Warren Buffett made a buy or sell decision, Moody's would have to withdraw a rating. Furthermore, if competition is the aim, why do the guidelines suggest that agencies should have their methodologies "preapproved" by the European Securities and Markets Authority (ESMA), their new regulator? That sounds like a way of imposing uniformity rather than allowing competing views to flourish.

If all these rules were pushed through, there would be a serious breakdown in the business of rating European debt, not a helpful development when the continent is already too dependent on its banking system for finance. The suspicion is that these proposals are designed to make room for a new European ratings agency which would be more sympathetic to the continent's needs.

This agency—let's dub it Pangloss—would follow European "cultural norms". When it comes to French debt ratios, say, it will add two and two and make three. Perhaps Europe will stumble down this road of self-deception and force its domestic investors to follow suit. But it won't fool the international investors it needs to buy its bonds. The draft paper should get a D rating for desperation and disingenuousness.

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