Christian Noyer: Possible ways of improving the process of rating

Speech by Mr Christian Noyer, Governor of the Bank of France, at the Symposium on financial ratings, organised by the Cercle France-Amériques, Paris, 12 December 2007.

* * *

Ladies and gentlemen,

It is a great pleasure and honour for me to speak at this conference organised by the Cercle France-Amériques and close the rich and lively round table discussions and the previous speeches on rating agencies and the financial crisis.

In the current state of turmoil, rating agencies have attracted a large amount of criticism. My intention is not to enter into this discussion, but rather to make a few remarks on the rating process itself and the possible ways of improving it, in the light of the recent events.

Preliminary remarks

An essential function of financial markets is to collect and process information. This information is used to assess the risk and return on the various assets, and therefore to help price discovery and more generally to take investment and financing decisions. However, the process by which this information is factored into prices is complex. Economic agents do not all have the same access to data and processing capacities. There is therefore an asymmetry of information on the markets, which is at the root of well known market failures: adverse selection (whereby lower quality investments are more readily financed than “good” projects) and moral hazard (which encourages investors to take excessive risks). But more importantly, gathering and processing this information is costly. There is no incentive for the various investors to incur these costs if they believe that others will do it and thus ensure the efficiency of the market.

When banks are engaged in financial intermediation, they gather and process the information concerning their borrowers through their customer relations. Bank intermediation is therefore a means of overcoming the problems of the asymmetry of information and its accessibility. However, on a securitised market, where borrowers are directly in contact with lenders, this solution does not exist. The rating system is an answer to the problem, as it enables all players to have access to simple, clear and concise information on the credit risk attached to the various classes and categories of financial instruments. The rating activity has expanded in parallel with that of bond markets. All major issuers are now rated by one or more rating agencies. For them it is a sine qua non condition for widening their investor base. The rating system goes hand in hand with the development of large liquid, deep and international markets. It is a precondition and a tool for ensuring the smooth functioning of these markets.

Securitisation, as we know it today, and which underpins national and international financial activity, would be impossible without these ratings.

A further step was made with the expansion of structured products. The role of rating agencies now extends well beyond that of mere information providers. The rating process is an integral part of the design and financial engineering of these products: it determines the size of the tranches and the seniority levels. The rating of a structured product is not an average of the ratings of the underlying assets, in particular for CDOs. It depends on both the correlation between the yield on the various securities and the leverage effect embedded in the structure. Rating agencies supply the methods and models for assessing risks and their correlation. They impose the (liquidity, credit enhancement) conditions that the securitisation vehicles have to meet in order to be able to issue. From mere intermediaries, they have become quasi securitisation regulators. As a result of their new role and functions, they are now being held responsible for the excesses, malfunctionings and turbulences that have been prevalent on structured product markets for the past three months.

Rating activity and current turbulences

The question is not to assign responsibilities, and even less to enter into a blame game. The rating of structured products has nevertheless led to a deep misunderstanding between investors and agencies. There are two reasons for this misunderstanding.

The first – the most often referred to – is the confusion surrounding the actual scope of the rating. Rating agencies consider themselves responsible for solely assessing credit risk, while many fund managers, in particular of short-term investment funds, may have expected that ratings would cover all the risks (notably liquidity risk) that weigh on their investments. Naturally, one may consider that these managers were – or should have been – informed of the exact nature of the rating process. However, one cannot deny that their expectations are natural: the smooth functioning and fluidity of the market are based on the provision to all economic agents of simple, clear and concise information on all the parameters that affect the risk-return ratio. This is particularly the case for AAA-rated investors. Contrary to investors in the riskier tranches, which are theoretically more sophisticated, they have less incentive, given the low return on the products, to thoroughly analyse the nature and sensitivity of the ratings. They are therefore more dependent on rating agencies.

In addition, investors' trust in the rating process may have been encouraged by the regulatory and prudential system, which uses ratings as a basis for steering the investment strategies and decisions of the institutions in charge of collecting public savings.

The second source of misunderstanding stems from the metric used for rating structured products. It is identical, in terms of presentation, to that used for traditional bond products. Yet, the two universes are different. The consequences of assigning a AAA rating to a CDO and to a corporate bond are not the same. The risk profile is different. The potential volatility of a AAA rating for a structured product, in particular, is far greater than that for a traditional product (for a shock, all other things are equal, of the same magnitude). Structured products are built on correlations and leverage. If one of the riskier tranches is affected by a default, the value (and the rating) of the other tranches will also be affected by contagion, through the decrease in their subordination level. Of all asset classes, CDOs are those whose rating is the least stable over time. To give just one extreme example, a AAA-rated CPDO was recently downgraded by nine notches in one day.

For investors, a AAA rating has traditionally been associated with a stable investment. It is now evident that there are stable AAAs and less stable AAAs, which considerably reduces the clarity of ratings. It would have been simpler to adopt a specific metric for structured products and, by doing so, many misunderstandings that were responsible for the current turmoil could have been avoided.

Avenues for the future

Hopefully these thoughts will open up some avenues for the future. I believe that there are two symmetrical pitfalls to be avoided.

The first would be to continue as before, with a few minor changes to the existing system. The turmoil observed over the past three months, and its potential impact on the real economy, are too important. Furthermore, the rating process will inevitably play a key role in the implementation of Basel II. This will involve a more refined assessment of risk, in particular through the promotion of internal models, and greater use of external ratings.

The second mistake would be to rush into the regulation of rating agencies. We cannot rule out that, at some stage, such regulation may become necessary. After all, information is a public good and rating agencies are the providers of this good. But the case for further regulation has not as yet been compelling.

First and foremost, we should consider the contents of possible improvements. I would pinpoint three areas, among others, for consideration: first, greater transparency of rating methods and the overall role of rating agencies in the securitisation process. Second, a marked difference in the metric used for rating bonds and structured products, which would restore confidence in ratings. This could be done in two ways, which could also be combined: either by adopting another rating scale for structured products (with another symbol for example); or by including an additional measure in the credit rating, in particular on its volatility in times of market or liquidity stress. Third, a specific rating for liquidity risk. I am aware that rating agencies are considering this, despite the difficulties of such an exercise. We must hope that the discussions currently underway in international fora, such as the FSF and groups of central bankers in which the Banque de France is actively involved, will restore the integrity of the ratings system, given its prominent role in the development of modern financial markets.

Ladies and gentlemen, thank you very much for your attention.