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Europe's War on Downgrades

European regulators may suspend ratings of nations that are being bailed out. Is that wise?

More Ratings, Not Fewer

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In the midst of a crisis, politicians and regulators all too often believe they can restore "confidence" by silencing the bearers of bad news. Witness the common banning of short selling whenever bank stocks take a tumble, as if speculators were to blame for the problems at Lehman or Fannie Mae. The latest chapter in this sad story is the attempt by European regulators to muzzle the rating agencies. Ultimately these efforts will do more harm than good, as confidence must eventually derive from fundamentals rather than the suppression of facts.

Without a doubt the rating agencies were behind the curve in regard to mortgage-related assets. They have, however, been quite timely and accurate when it comes to rating sovereign debt. The largest rating agencies were warning of problems in Greece long before the markets really took notice. More important, the bias of the agencies has all been in one direction: inflating a security's rating.

Europe, however, is not complaining about being given AAA when it is undeserved. Europe ultimately wants to stop downgrades, reducing the accuracy of ratings. If Exxon or Apple demanded a suspension of rating changes because the company was undergoing a restructuring, we would see such a demand as abusive to investors. Yet when governments demand the same manipulation, it is sadly taken seriously.

> Whatever their mistakes on mortgage-related assets, the rating agencies have been timely and accurate in grading sovereign debt.

Of course the E.U. claims it wants to eliminate the "conflicts of interest" between the issuers of debt, who often pay for the ratings, and the agencies that provide those ratings. If investors were truly free to decide on the merit of ratings, rather than required by regulation to use them, then this conflict of interest could be solved via reputation. And while the E.U. proposal might lessen this problem, it does so at the cost of creating a far bigger one: the conflict of interest between governments and rating agencies.

As witnessed by S.&P.'s treatment by the U.S. government, after it downgraded the U.S., having the rating agencies regulated by the very entities they are supposed to rate is a recipe for abuse. Instead of trying to create its own rating agencies, to avoid inconvenient truths about government finances, Europe should do us all a favor by encouraging private, Europe-based rating agencies that would be beyond the reach of the U.S. government.

Topics: Economy, Europe, Greece