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The Supervisory Conflicts of the European Securities and Markets Authority: European Union Attempts to Regulate Credit Rating Agencies

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The European Union (EU) is determined to correct some of the governmental deficits in the ratings space. Centralised oversight of credit rating agencies (CRAs) at the European level is a principal feature of its regulatory response. The new European Securities and Markets Authority (ESMA) is charged with monitoring CRAs. However, the current framework leaves it vulnerable to supervisory conflicts which can undermine ESMA's objectives and its capacity to correct some of the more egregious elements of sovereign bond ratings. Analytical interference in the rating process is foreseeable in the assessment of new methodologies, models and assumptions. Informal judgment is necessary to gauge the severity of market disturbances and the suitability of proposed revisions. In the preservation of stability, the conflation of these categories can further compromise ESMA's authority. Simultaneously, ESMA may be placed in the awkward position of pursuing the conflicting objectives of enhanced stability and increased competition. Severe conflicts of interest would only compound its mandate and make the EU more susceptible to destabilising attacks.

Keywords: credit rating agencies; European Union; risk and uncertainty; sovereign debt crisis; financial governance; European Securities and Markets Authority

Introduction

Plagued by the persistent threat of or actual credit rating downgrade, the European Union (EU) is desperately attempting to allay fears concerning eurozone disintegration. Amidst the 2007-08 credit crisis, and subsequent sovereign debt woes, the European Commission (CEC 2010a, 2011a) identified several deficiencies in both the operational elements and supervision of the credit ratings space. Four outstanding factors are thought to exacerbate the sudden and disruptive 'cliff' and contagion effects of sovereign debt ratings which can destabilise financial markets and governments alike. Chief among these potential hazards is an 'overreliance' on (often dubious) external ratings. Furthermore, concerned about the lack of competition in the ratings space – Moody's Investor Services (Moody's), Standard and Poor's (S&P), and Fitch Ratings dominate the market – the EU is convinced that more actors and greater diversity would be advantageous. New entrants can also enhance the transparency of the ratings process, and thus improve the quality of ratings themselves. Greater accountability is deemed necessary (Kerwer, 2005; Partnoy, 2006). Of course, identifying the obstacles jeopardising the stability of the EU's financial system is only the first step. 'Ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection' is proving much more difficult (ESMA, 2012).

In order to redress these operational problems, the High Level Group on Financial Supervision (ESME, 2008), chaired by Jacques de Larosière, applied itself to scrutinising credit rating agencies and identified three key areas for oversight improvement: registration, conduct of business, and supervision. Similar investigations where conducted in Germany (Issing Committee) and the UK (Turner Review). One of its core recommendations was to centralise surveillance of ratings agencies at the European level with the creation of a new independent EU Authority: European Securities and Markets Authority (ESMA). From July 2011, ESMA has replaced the Committee of European Securities Regulators (CESR) as the exclusive regulatory body entrusted with the responsibility for the registration and supervision of CRAs; including launching investigations, conducting inspections, proposing fines and prohibiting operations. Can closer supervisory convergence across Europe and a single rule book – including the preparation of new technical laws and standards –supposedly enhance the surveillance of what is largely a depoliticised field of finance? What are the possible conflicts that arise from ESMA's new supervisory roles/functions?

Given ESMA's limited supervisory experience, coupled with the implicit uncertainty of fiscal relations – and thus the construction of sovereign ratings – the EU's objective to respect the independence of Moody's or S&P and avoid interfering in the substantive content of their ratings is dubious. ESMA's discretionary conduct threatens to politicise the ratings process and prejudice the responsiveness of sovereign ratings to changing market conditions. As tempting as it is to correct some of the imbalances and inconsistencies evident in sovereign ratings in the hope of curtailing their destabilising effects, I contend that ESMA is assuming risks for which it is neither prepared nor mandated to manage.

ESMA is adamant about not interfering with the content of ratings or the methodologies of CRAs (Article 23). Markets must be allowed to operate effectively and efficiently without regulators determining the analytical substance of ratings. Bureaucratic intrusion may distort the qualitative dimension of sovereign bond ratings. Irrespective of the disproportionate promotion of quantitative criteria and risk calculus in the assessment of a sovereign's propensity towards fiscal failure – codified and commercialised as the 'risk of default' – and its analysis in the conventional literature (Cantor and Packer, 1995; Dittrich, 2007; Lowe, 2002), sovereign ratings ranges rest on a judgement about the extent of the political 'capacity and willingness' (Moody's, 2008: 4) to subject constituents to 'tolerable' costs of adjustment. Probability of payment depends on the tolerability of the (socio-political) costs of austerity; which cannot be readily captured through purely quantitative techniques that attempt to aggregate (unique) national fiscal relations into common pools of risk. Informal estimations are a necessary element of credit analysis (Paudyn, 2011; Sinclair, 2005: 176). Secretive and opaque, however, the accommodation and synthesisation of these qualitative (uncertainty) and quantitative (risk) parameters in never revealed. Thus, whether ESMA can simultaneously respect these ambitions and correct some of the more egregious elements of sovereign bond ratings to make the EU less susceptible to destabilising attacks is questionable.

New provisions in the latest amendment (CRA Regulation v3) to the CRA regulatory framework – Regulation (EC) No 1060/2009 (CRA Regulation v1) and its first amendment (EU) No 513/2011 (CRA Regulation v2) – pose potential serious regulatory conflicts which may undermine EU attempts to manage the politics of creditworthiness effectively. Two outstanding supervisory conflicts threaten to jeopardise ESMA's management of the ratings space. First, potential analytical interference exists in the assessment of new draft methodologies as a condition for their entry into force. Especially troublesome with regards to sovereign debt – where the contingent nature of fiscal relations precludes rating methodologies from being applied automatically or exclusively reliant on quantitative criteria – both the current regulatory technical standards (RTS) (Article 8(3)) used to assess the compliance of CRA methodologies with EU Regulation or the alternative suggestion of principle-based industry standards for rating processes demand that ESMA officials exercise a high degree of informal judgement. Not only is its limited monitoring experience compounded by an understaffed office – from 15 at the beginning of 2012, it will only grow to 20 by the end of the year – but ESMA's pertinacious adherence to CRA independence may leave the regulatory process vulnerable to cooption by Moody's or S&P. Evading qualitative intrusion, ESMA's may simply rubberstamp rating methodologies and models rather than seriously evaluating their operational quality and utility.

Second, ESMA is charged with assessing market concentration levels and related risks. Typically within the jurisdiction of competition supervisors, such as DG Competition, ESMA will have to devise new skills to ascertain potential dangers stemming from the highly concentrated market. Although six of the sixteen registered CRAs issue sovereign ratings at present, only the main three can truly be labelled as global full-spectrum rating agencies; with Fitch a notable, but distant third in terms of prominence (Kruck, 2011; Sinclair, 2010: 98; White, 2002). Simultaneously, ESMA is mandated with ensuring stability, which entails avoiding frequent, and therefore disruptive, rating revisions. Combined together, these responsibilities may place ESMA in the uncomfortable position of pursing two, ostensibly, conflicting objectives. Greater diversity may be desirable but the proliferation of available ratings increases the chance of multiple modifications and makes them more difficult to patrol. Stability can be compromised.

Conversely, restricting the circulation of additional ratings only works to reinforce Moody's and S&P's monopolistic grip on the market. Both the European Commission (2011a) and the US Securities and Exchange Commission (SEC, 2009) calculate that the big three CRAs are responsible for a staggering 95-97 percent of all outstanding ratings across all categories. Distressingly evident in regards to sovereigns, it is this sheer dominance that the EU wishes to disturb. Commission intentions, however, to fund smaller CRAs, as the EU actively seeks to promote the emergence of a broader rating agency network, can exacerbate this conundrum. Conflicts of interest may arise when an EU-sponsored agency is rating the sovereign debt of its masters; hence a reason why the EU scrapped its proposal for a quasi-public EU Credit Rating Agency.

Excessive preoccupation with stability can also endanger ESMA's goal of non-interference. Procedural stability may be enhanced by new provisions in Article 8(3) stipulating that methodologies must be 'continuous'. Rating methodologies should only be altered if there is an 'objective reason' for such modification; which is most often precipitated by 'changes in structural macroeconomic or financial market conditions' (ESMA, 2011b/462, Art.6). Subjective estimations, however, are necessary to gauge the severity of any shock and the suitability of proposed revisions to the rating methodology, models and assumptions. In the preservation of stability, ESMA may conflate these categories and place itself in the awkward position of analytically assessing whether the proposed changes are warranted and valid.

Underpinning all these potential supervisory conflicts is the uncertain nature of fiscal relations and the corresponding managerial techniques available to ESMA. This paper contends that ESMA must come to terms with how sovereign debt is rendered as a 'problem of government' through specific 'techniques of truth production' (Foucault, 1980), which endow it with a 'social facticity', and thus amenable to various forms of intervention. Representations demarcating the limits of debt financing, and thus fiscal government, reflect a logic that seeks 'to create the calculating [state] as a resource and an end to be striven for' (Miller, 2001: 381). Here credit ratings act as an internal form of governmentality underpinning budgetary relations as opposed to brute facts. To be effective, ESMA must target how CRAs operationalise and deploy the discursive practices of risk and uncertainty. This entails adopting both of these modalities itself. Yet, such conduct threatens to compromise ESMA's principle of non-interference as it entangles it in the distortion of the politics of creditworthiness to an undesirable extent.

To demonstrate how detrimental these supervisory conflicts can be to the integrity of ESMA in its efforts to manage the ratings space effectively, the following argument proceeds along two main tracks. In the first part, given the analytics of sovereign bond ratings, I contend how contestable the assessment of rating methodologies is and why ESMA is neither properly prepared nor really sanctioned to execute such evaluations. Both the current criteria of Article 8(3) and the principle-based alternative demand that the EU exercise more discretionary conduct than warranted. The second half of the article addresses the dilemmas which may arise as ESMA seeks to strike a balance between maintaining stability and fostering competition in the sovereign ratings space. Tremendous barriers to entry are not the only obstacles to surmount. Possible conflicts of interest stemming from Commission attempts to establish a competitive network of agencies to rival

Moody's or S&P merely complicate matters. Although additional regulatory measures are necessary to compensate for the inadequacies of a fragmented supervisory regime, the current CRA framework exposes its central regulatory institution, ESMA, to a slew of conflicts which can potentially make a bad situation worse.

Uncertain Fiscal Relations

In order to properly grasp the precariousness of the enterprise upon which ESMA is embarking, it is first vital to understand one of the principal, yet most contentious, objects of its governance: sovereign bond ratings. Sovereign creditworthiness is assessed through an arsenal of quantitative risk calculus (Kerwer, 2005; Moody's, 2008; S&P, 2011a) which seeks to compute the debt-bearing capacity of an entire nation by disassembling governments into analytical categories, such as the 'political risks' or 'fiscal flexibility' located in S&P's (2011) Rating Analysis Methodology Profile (RAMP), and then supplements this with subjective estimations to account for the uncertain vicissitudes unleashed by the 'singular nature of sovereignty' (Moody's, 2008: 6). To 'capture both capacity and willingness to repay debt...a synthesis of qualitative measures and qualitative judgements' is necessary (ECB, 2011: 3). But determining 'default' itself remains contested, with Moody's privileging expected loss and the ability to pay while S&P evaluates default probability along with the willingness to pay and Fitch relies on some aggregation of the two. Sovereigns rarely default and fluid fiscal politics evade being readily captured in a probability distribution of risk. Reluctant to provide such key regulatory definitions itself, ESMA's deferral to rating agencies attenuates its authority.

In order to mute this 'special' status of sovereigns (Moody's, 2008: 5) and make their budgetary relations more tractable to the rational choice methodology and stress tests implicit in CRA propriety models, Moody's employs a five-point scale – S&P a one (the best) to six (the worst) format – where risk scenarios are coupled with comparative metrics to assess a country's economic resiliency and the government's financial robustness. A 'narrow rating range' is compiled; whereby Member States are synchronically standardized through an ordinal ranking of credit risk and then compared. Of course, Moody's admits that:

> there is no quantitative model that can adequately capture the complex web of
> factors that lead a government to default on its debt. The task of rating sovereign
> entities requires an assessment of a combination of quantitative and qualitative
> factors whose interaction is often difficult to predict. (Moody's, 2008: 1)

S&P confirms the difficult discretionary nature of connecting these quantitative (risk) and qualitative (uncertainty) variables together conceding that 'there is no exact formula for combining these scores to arrive at a ratings decision' (S&P, 1992: 15). How 'the committee views one category depends upon other categories and trends as much as upon the absolute level of many measures' (S&P, 2008: 2). Nevertheless, both are adamant that 'qualitative elements are integrated within a structured and disciplined framework so that subjectivity is constrained' through the 'continuous effort to make the analysis more quantitative' (Moody's, 2008: 6). In other words, there is a concerted effort to transform (singular) fiscal uncertainties into (aggregate) pools of risk.

Suspending the search of the 'real' ontological coordinates of risk and uncertainty opens us to the governmental dimensions of this problematic. Through the construct of risk, sovereign debt is rendered intelligible as primarily a quantifiable frequency of fiscal failure (Cantor and Packer, 1995; Reddy, 1996). Management through uncertainty cannot be systematically orchestrated because it fails to reproduce itself at regular intervals (de Goede, 2005; O'Malley, 2000). Informal judgement and seasoned guesswork play a greater role. Treating them as modalities of government relieves us of the burden to search for ontological equivalence in fluid fiscal relations, as neither risk nor uncertainty is 'inherently' more or less abundant during the sovereign debt crisis. Deployed in various configurations, risk and uncertainty help constitute authoritative knowledge surrounding sovereign debt and its subjectivities (i.e. investors, Member States).

Orthodoxy dictates that the more supposed uncertainty that CRAs replace with risk, as they attempt to aggregate contingent fiscal relations into a calculable measure of variance around an expected value – represented as

AAA – the more consequential ratings become (Kerwer 2002; Reisen, 2003; Sinclair, 2005). Technical expertise mediates this representational process of surveillance as regulation through the deployment of calculative techniques (Maurer, 2002; Miller, 2001). Defendable risk calculus acts as a powerful managerial tool with 'depoliticising' effects on the decision-making process; whereby political discretion becomes increasingly marginalised and censured through normalising mathematical models (Langley, 2008; O'Malley, 2004). Practices of risk strive to control performance by ensuring that discretionary (read political) misconduct is mitigated and the discourse depoliticised. Such a mentality is noticeable in the push to increase the surveillance authority of risk through measures like credit-scoring systems (Leyshon and Thrift, 1999), reputational metrics (Power, 2007) or credit ratings (Sinclair, 2005). Ostensibly, this works to shield technical knowledge from contestation by 'immunizing decision-making against failure' (Luhmann, 1993: 13). Accountability is undermined as external ratings divorce CRAs from the consequential effects of their products (Kerwer, 2005).

Communicated through these sovereign ratings is a 'programmatic' dimension which privileges disinflationary logics aligned with Anglo-American forms of capitalism (Nölke and Perry, 2007: 123). An austere 'fiscal normality' is constituted, entrenched and regenerated through inter-subjective modulation aligned with these socio-technical devices of control through which (European) sovereign debt is made into a problem of government (Callon, 1998; Deleuze 1995; Knorr and Preda, 2005; MacKenzie; 2006). Sovereign ratings serve as an internal form of governmentality underpinning this neoliberal governance. Deviance from this prescribed budgetary approach in, for example, the form of stimulus, and hence a credit downgrade, can bring about serve public consequences as the costs of financing programmes of national self-determination, such as education or regional transfers, balloon.

Because of the diversity and contingency implicit in EU fiscal relations, local knowledge of national political economics is crucial in estimating creditworthiness. The 'pain' from austerity that the Greek or Portuguese populations are willing to tolerate differs from the threshold of that of the Dutch or Germans. Acknowledging that 'political risks are among the main drivers of the poor economic policies that lead to default', S&P (2011a: 9) submits that, irrespective of its asset position, a government with a political score of ‘6’ cannot be rated higher than ‘BB+’. To calibrate this score, ‘U.S. agencies acknowledge the legitimacy of local knowledge but from within the context of a highly centralized system of global comparison, premised on instrumental, synchronic knowledge’, which is especially conspicuous ‘when it comes to “credit-related political fundamentals”’ (Sinclair, 2005: 148). Variegated notions of fiscal normality – reflecting unique political economies – and differentiated ratings are not accommodated by the aggregating techniques of risk. As the degree of contingency implicit in the construction of sovereign ratings is masked or misrepresented in favour of uniform risk calculus, sovereign ratings institutionalise a form of dysfunctional information exchange. This skewed analytics of ratings can have profound destabilising consequences on national economies and financial markets.

ESMA must take concrete measures to dress this fallacious analytics of ratings which distorts (uncertain) fiscal relations and commodifies them through hegemonic risk management. Given the significant degree of (obscured) subjective judgement involved in the construction of sovereign ratings by CRA committees, the EU will be forced to interfere in their analytical substance. Contestable interpretations about compliance are sure to abound; especially if nebulous and debatable principles are adopted. Heated spats between the EU and CRAs have erupted with virtually every recent downgrade, such as Moody’s (2011a) relegation of Portugal’s debt to Ba2 (Ba3 at the time of writing - negative outlook) on 5 July 2011 or S&P’s (2012a) cut of France to AA+ on 13 January 2012. There is nothing impeding such controversies from repeating themselves; especially when so much is on the line as states are denied their traditional countercyclical roles. Conversely, for the reasons identified above, primarily focusing on the verification of quantitative elements is not a feasible alternative either when it comes to sovereign creditworthiness. The conflicts which surface are introduced in the following sections.

Assessment of Rating Methodologies

In the attempt to reduce the overreliance on external ratings and redress the competition deficit, the EU is seeking alternative forms of appraising the creditworthiness of sovereigns. Different approaches to calculating credit risk may also have a countercyclical effect. Yet even the EU acknowledges that most common measures, such as market data where expectations of default are reflected in bond prices or credit default swap (CDS) spreads, have a procyclical bias (CEC 2010a). Price swings can translate into greater capital requirements and potentially more volatility. Reluctant to promote a model not sanctioned by the market, new supervisory powers prohibit ESMA from intruding into CRA analytical assessment or articulation of creditworthiness. Article 23 stipulates that 'in carrying out their duties under the [CRA] Regulation, ESMA, the Commission or any public authorities of a Member State shall not interfere with the content of credit ratings or methodologies'. In principle, the logic of a market-driven regulatory regime is understandable. Bureaucrats lack the competence and resources to appraise creditworthiness adequately. Yet this is exactly what the current framework may compel ESMA (inadvertently) to do.

Analytical interference is anticipated given the uncertainty implicit in the fiscal relations being monitored. Whereas risk calculus is more plausible with corporations because of their higher incidence of bankruptcy, unique fiscal sovereignties demand tailored, and responsive, credit risk methodologies. Otherwise, if these methodologies, and by extension their sovereign ratings, neglect the contingency of fiscal relations, and distort qualitative elements as quantitative variables, their assessments are incomplete and/or inaccurate. Resiliency – 'the ability of the sovereign to face adverse economic, financial and political events without having to impose an intolerable economic sacrifice on its population' (Moody's, 2008: 6) – is a highly qualitative calculation. This knowledge cannot be acquired primarily through risk techniques. Uncertainty includes risk but not vice-versa. Informal judgements may incorporate statistical probabilities but the latter strives to exclude discretionary variables (O'Malley, 2004). Since standardising (budgetary) contingency is impossible, it is essential to recognise its role in the construction, and regulation, of sovereign ratings. The politicisation of the rating process is expected as variegated notions of fiscal normality underpin the production of (differentiated) sovereign rating methodologies.

A certain degree of overzealousness is reasonable to expect given the incipience of this regulatory enterprise. Without experienced personnel, the nascent stages of ESMA's tenure will be an arduous ordeal characterised by trial and error. Its responsibility is to:

> consider whether a credit rating methodology has a demonstrable history of consistency and accuracy in predicting credit worthiness and may have regard to methods of validation such as appropriate default or transition studies designed to
> test that specific methodology. (ESMA, 2011b/462, Art.3.3)

I have already noted the difficulty in assessing what constitutes as 'appropriate default' in relation to diverse sovereigns. Even more painstaking is the dominant approach that ESMA has adopted to verify whether CRA methodologies are 'appropriate' or 'objective'.

Irrespective of the qualitative uncertainty of fiscal politics, ESMA's methodological focus is primarily skewed in favour of quantitative risk measures; which treat sovereign debt identically to corporate debt. No specific provisions for sovereigns are included in the regulation to make contingent liabilities more explicit. Rather 'key assumptions and quantitative and qualitative criteria are validated (ex-ante) and reviewed (ex-post) through appropriate forms of back-testing' (ESMA, 2012a/3, III.IIf). Demanding continuous validation 'supported by statistical, historical experience or evidence' (ESMA, 2011b/462, Art.4.1a) – where actual defaults are compared with the probabilities of default predicted in transition matrices – the EU is asking for representative data samples of fiscal politics that just do not exist.

This risk mentality parallels that of private CRAs. S&P (2008: 11) concedes that 'comparative statistics are affected by the small number of rated sovereign defaults', but given the 'same rating definitions', it 'expects sovereign default probabilities to be closer to private-sector ratios over time'. Dubious claims such as this flow from an excessive reliance on probability convergence implicit in repetitive risk metrics. Their application to contingent fiscal relations distorts both the assessment of sovereign debt as well as the verification of its methodological compliance because, as Moody's (2008: 13) admits, there is ‘no quantitative-based approaches that satisfactorily replace analysts’ disciplined judgment on these questions’.

Where dilemmas arise about the calibration of ‘political risks’, such as a ‘clear process of succession’ or the ‘robustness of political institutions’ (S&P, 2011a: 10-11), ESMA (2011b/462, Art.4 (2a)) instructs CRAs simply to submit ‘the scope of qualitative judgment’ in such contestable areas. How such an ambiguous request can be satisfied is daunting to fathom; much less institutionalise across the board. ESMA’s answer to this conundrum is equally nebulous. Should ‘limited quantitative evidence to support the predictive power’ of the rating methodology exist then its validation can be secured if ‘*sensible* predictors of credit worthiness’ are available (ESMA, 2011b/462, Art.7 (6), added italics). Without doubt, or a clear definition, determining what constitutes as ‘sensible’ in relation to diverse, national political economies is not only mindboggling but open to numerous conflicting interpretations. Either ESMA will defer to Moody’s or S&P to define the parameters of sensibility, and witness its oversight authority diminish, or it will be dragged into these heated debates and be required to make the exact kind of informal judgements about the analytical substance of rating methodologies and models which it so desires to avoid. Again, under these conditions, the politicisation of the rating process seems to conflict with EU regulatory ambitions.

These headaches can only be compounded by ESMA’s obligation to decipher if Moody’s or S&P are, indeed, applying ‘internal procedures in a consistent way over time and across different market segments’ (ESMA, 2011b/462, Art.7 (6)). Consistency is an admirable objective. But even the Commission (2011b: 15) admits that the ‘important degree of subjectivity of the sovereign rating process’ and ‘the lack of consistency of CRA’s behaviour over time’ contribute to a ‘substantial increase of the “arbitrary component” of sovereign ratings...and point at the existence of subjective biases in favour or against rated nations’. Similar conclusions have been empirically demonstrated by Gartner, Griesbach and Jung (2011). Although the visibility and resiliency of rating agencies to remain at the heart of global finance are well documented (Dittrich, 2007; Gamble, 2009; Hill, 2004; Partnoy, 1999, 2002; Sinclair, 2010), the actual analytical determination of creditworthiness is highly secretive as the synthesis of the qualitative and quantitative techniques remains distinctively opaque (Sinclair, 2005: 33). Not surprisingly, CRAs prefer to not disclose the exact thought processes involved in arriving at a rating judgement because that would entail having to explain the subjective (read biased) nature of these decisions (Johnson *et al*, 1990). Rather they prefer to shield themselves from this attack through the 'objectifying cloak of economic and financial analysis' (Sinclair, 2005: 34). As mentioned above, defendable risk calculus has a depoliticising effect.

Neither is ESMA privy to how internal judgements are, in fact, rendered by CRAs nor is it equipped to evaluate the 'sufficiency' or 'sensibility' of these contingent liabilities without predicating such assessments on the subjective intrusion into the rating process. Arguably, this conflict would only be exacerbated if principle-based industry standards were to be adopted. ESMA is quite hesitant about revealing what such a scheme would entail. Commonly agreed upon with industry actors, these principles would guide ESMA in its supervision of CRA conduct. But whereas the risk dominant approach to rating methodologies and their regulation makes ESMA complicit in the distortion of fiscal relations by yielding to the imposition of an artificial budgetary normality as the measure of fiscal prudence or profligacy, this system would open the floodgates to a plethora of disparate notions about what that actually constitutes. If the example of 'sensibility' is indicative of how arduous an ordeal it may be to establish the correct interpretation of a principle then one must be incredulous of how consonant this proposition can be with ESMA's supervisory objectives. Alternatives, such as ambiguous principles, expose the EU to inevitable, frequent conflicts about the actual compliance of rating methodologies and models with these obscure commands; which endanger the analytical independence of rating agencies. Excessive leniency, on the other hand, in the definition and application of these principles leaves regulatory oversight vulnerable to cooption by Moody's or S&P as they interpret the rules in their favour.

Stability versus Competition

CRA Regulation v3 proposes to enhance the transparency and disclosure of sovereign creditworthiness. For this purpose, the issuance of sovereign ratings will become more frequent – from every twelve to six months (Article 8(5)). Timely ratings may also be more reliable. ESMA is concerned that unwarranted adjustment delays can trigger speculative attacks and market volatility. Responsiveness to changing economic conditions, however, needs to be balanced against the disruptive effects of excessive revisions. Stability decreases with unreasonably frequent changes in the content of rating methodologies.

With stability in mind, the EU is also adamant about accelerating the introduction of new entrants into the market. Arguments in favour of increased competition and diversity of ratings are essentially without opposition (CEC, 2010a; ECB, 2011; FSB, 2010; IMF, 2010). By definition, monopolies are inefficient (Friedman, 1962/1982). Now the painstaking task is to determine how to enhance participation effectively – preferably through private entities – and disturb the privileged position that Moody's, S&P and Fitch enjoy. What results is a potential supervisory conflict between the simultaneous promotion of stability and competition.

Breaking into any competitive market is a formidable challenge. Penetrating the hermetic enclosure of the ratings space, however, is virtually unfeasible given the oligopolistic configuration of the industry. Moody's, Standard & Poor's and Fitch dominate the market. Of course, Sinclair (2010: 98) has identified developing 'competition' as one of the three defining characteristics of the growth phase of ratings over the past decade – the other two being 'internationalisation' and 'innovation'. Yet, in light of the tremendous intersubjective barriers to entry (e.g. reputation) and economies of scale and of scope, all these minor rating agencies, such as ICAP Group SA of Greece or the Bulgarian Credit Rating Agency AD, pale in comparison to behemoths like Moody's (2011b) or S&P (2011b) who, in 2011, rated 112 and 126 sovereigns, respectively. At 59 sovereign ratings, but with some stretch of the imagination, Kroll Bond Rating Agency (KBRA) (2011) may be considered as a potential challenger. Most new entrants, therefore, seem resolved at carving out niche specialisations rather than aspiring to become global full-spectrum rating agencies (Sinclair, 2010: 98). For example, Dominion Bond Rating Service Ltd. (DBRS) of Canada focuses on global-corporates and structured finance, while Japan Credit Rating Agency Ltd and Rating and Investment Information Inc. have set their targets primarily on Japan.

In order to become credible competitors, the reputational capital that smaller-sized CRAs need to build in order to effectively steal market share and clout away from Moody's or S&P is immense. As a social construction, Power (2007: 129) posits that 'reputation' connects questions of legitimacy and authority with organisational identity. It involves 'creating an account of an organization, embedding that account in a symbolic universe, and thereby endowing the account with social facticity' (Rao, 1994: 31). Convincing private fund managers or banks to listen to the lower rungs is daunting. Nevertheless, the EU is determined to dilute this high concentration and offer greater choice for investors. By addressing the lack of comparability and financial barriers to entry, the Commission hopes that the development of a broader rating agency network will help build the necessary reputational capital; thereby establishing it as a credible alternative to the status quo.

Tremendously disadvantaged in relation to their larger and more mature counterparts, the majority of these small entities employ less than 50 staff and issue a limited amount of ratings in specialised (local) markets. Conversely, Moody's (2012b), which reported revenue of $2.3 billion in 2011, employs an approximate global workforce of 6,100 while maintaining a presence in 28 countries, and S&P tower above them. Disproportionate hurdles the likes of these cannot be surpassed by any individual small CRA. Thus, at a projected annual cost ranging from € 0.9-1.95 million, the Commission (2011a) is exploring various schemes to finance a voluntary network, the European Network of Small and Medium-sized Rating Agencies, which would assist these CRAs to break the entrenched monopoly. The (ambitious) aspiration is to 'facilitate the sharing of best practices and resources and eventually lead to the emergence of more sizeable market players which would compete in terms of size, instruments rated, geographic reach and reputation of the large CRAs' (CEC, 2011a: 40). Lacking the necessary economies of scale or reputational capital, the only real credible option that these firms possess in gaining market share is to collaborate in areas such as common IT systems (e.g. one rating platform) or data exchange. Given the absence of requisite market forces, however, they require funding from the EU to initiate this network.

Adequate financial incentives would help foster a pan-European network of 15 European CRAs over the medium term (5 years). Once this enterprise is established and fully functional, the co-financing would be reduced or withdrawn. Resources could be made available from two streams which will extend the Competitiveness and Innovation Framework Programme (CIP) from 2014 onwards. First, 'Horizon 2020' is the programme designed to fund research and innovation. Targeting small and medium enterprises (SMEs), a sum of € 17 938 million is allocated to industrial leadership in innovation; which includes major investments in key technologies, greater access to capital and support for SME (CEC, 2011c). Second, the new Programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME), which replaces the expiring CIP, is charged with facilitating access to finance for SMEs and increasing competition. It could be an eventual source of capital. Minimising the financial barrier to entry, however, is but one small step to realising the EU's ambitions. Negative externalities must also be considered.

Given the unsolicited nature of the vast majority of sovereign ratings – where the issuer-pays model of remuneration does not apply – the additional circulation of credit scores will be irrelevant unless financial institutions are convinced of their merits and renounce Moody's or S&P. To build its clientele base, the new network would have to lure issuers away from the big three. Grade inflation is a low cost and highly effective strategy for this objective. Quality itself may be compromised by the infusion of additional CRAs into the market. Studies reveal that the greater the numbers of CRAs, the lower the rating quality/higher ratings since companies have more options to shop around for a favourable appraisal (Becker and Milbourn, 2010). Generous ratings are an inexpensive tactic used to drum up business. Poor ratings adversely impact their revenue stream; whereas higher assessments are thought to attract more clients and generate richer profits. Particularly 'virulent regarding the rating of structured finance instruments', such as credit derivatives, the inflation of creditworthiness is not internalised by the CRA but by misguided investors (CEC, 2010b: 5). Profit-maximisation would remain a top priority for this network of private firms. Furthermore, merely switching subscriptions may actually jeopardise one of the EU's other primary objectives: reducing an overreliance on external forms of assessment. Multiple alternatives simply diminish the sense of urgency for market participants to replicate such tests themselves.

Apart from these problems, supervisory conflicts can surface. ESMA would need to develop new techniques as it assumes the responsibility of monitoring this network for its adherence to competition statues. Its limited experience, coupled with the fact that such oversight typically is the remit of DG Competition, may place ESMA in the awkward position of infringing on the analytical substance of the ratings process as it develops the skills necessary to gauge the appropriate balance of concentration and stability in the ratings space. As I have contended above, deciphering how a judgement of sovereign creditworthiness is constituted is a complicated and frustrating exercise. One the one hand, ESMA wants to preserve a continuous rating process without frequent revisions to either methodologies or ratings. Ostensibly, this is best achieved when there are fewer players to monitor. The infusion of competition complicates surveillance. On the other hand, increased diversity is a core ambition of the EU. Additional CRAs/ratings, however, could make the EU more vulnerable to fluctuations, and thus potentially compromise stability. Information exchange among network members could also violate European Competition regulations. Questions will abound regarding ESMA's interpretation and application of these rules.

Conflicts of interest may surface because the EU has a vested, financial interest in ensuring the success of this enterprise. Having an EU-sponsored CRA network assess the creditworthiness of the very sovereign governments with which it is affiliated is a cause for concern. Irrespective of the claims of independence uttered by the Commission, rating the debt of its masters could strip a quasi-public network – together with the issuing Member States – of its much coveted credibility; which would only aggravate the management of the debt crisis. Financing obligations would be severely impaired as markets disregard this certification as a farce. The infusion of uncertainty would drive credit-default swap (CDS) spreads – a popular measure of the market price of creditworthiness – even higher (IMF, 2010: 105). Together, these potential supervisory conflicts would undermine the ability of ESMA to manage the ratings space effectively.

Methodologies, Models and Assumptions

The RTS stress that an improvement in the quality of sovereign ratings is connected to the 'continuous' character of their methodologies (ESMA, 2011b/462, Art.6). 'Objective reasons' must be presented to justify either modification or discontinuance. Movements in 'structural macroeconomic or financial market conditions' are considered to satisfy this criterion. Yet, given the uncertainty of fiscal relations, how these shifts are interpreted in relation to political risks, and then incorporated into the rating process, leaves ESMA exposed to additional supervisory conflicts.

Adherence to these regulatory technical standards may potentially compel ESMA to confuse credit rating methodologies with analytical models and principal rating assumptions. Rating methodologies refer to the specific frameworks and processes which govern the application of criteria principles to produce a rating. Parametric statistics are an example of the (technical) methods employed by rating agencies to assess variables such as, in the case of corporates, current and future cash flows or the ability to cover expected interest expense for issuers in specific industry sectors (S&P, 2010a). In regards to sovereigns, the 'through-the-cycle' (TTC) rating methodology relies on such techniques to aggregate specific and dynamic knowledge about the obligor's debt position. Serious criticisms of the TTC, however, attack it for its procyclical bias (IMF, 2010) and for failing to capture adequately the translation of political movements into credit risk (Valles, 2006). Nigel Thrift (2004: 588) confirms that such quantitative methods 'rely on being able to establish repeatability, most especially by reducing the scope for variability' through the production of '"controlled" results'. But fiscal politics fails to reproduce itself at regular intervals. Nevertheless, more rigorous methodologies are purported to increase transparency, and thus stability. Determining the integrity and consistency of these quantitative measures –

without interfering in their analytical substance – entails reproducing the calculations themselves. Where ESMA is bound to experience more difficulty is with the models and assumptions which underpin sovereign ratings.

Models are 'a simplification of, and approximation to, some aspects of the world' (King et al., 1994: 50) that help rating committees analyse the shock-absorbing capacity and resilience of a sovereign. Stress scenarios implicit in these propriety models primarily rely on a synthesis of informal judgement and statistical probabilities to validate competing propositions about the willingness and ability of a sovereign to fulfil its obligations. How this occurs is never revealed. These hypothetical tests are associated with a particular rating category and are informed by their underlying premises. Assumptions are the 'projections, estimates, input parameters to models, and all other types of qualitative or quantitative expectations that [CRAs] use to arrive at a ratings opinion' (S&P, 2010a: 3). Together, they help analysts to identify and discriminate what constitutes as 'relevant' criteria and how these quantitative and qualitative factors should combine to formulate, as in the case of S&P, a Ratings Analysis Methodology Profile (RAMP), which then goes to the rating committee for discussion and an eventual vote. Explicit or otherwise, contingent liabilities are a constant fixture of the rating process; especially in the case of sovereign debt.

Whereas ESMA can verify if a method was calculated properly, its assessment of models and assumptions demands that informal judgement be exercised. After all, S&P (2012b: 7, added italics) concedes that 'rather than providing a strictly formulaic assessment' it 'factors into its ratings the *perceptions* and *insights* of its analysts based on their consideration of all of the information they have obtained'. Any comprehensive review of the appropriateness of these subjective estimations will entail some degree of analytical intrusion of the part of ESMA. Although the new RTS allude to these categories individually, methodologies, models and assumptions are never operationally defined.

In the preceding CESR guidance – the foundational framework for the RTS – these distinctions were obscured. There credit rating methodologies:

> refer to criteria, models, methodological principles for a particular rating or practice; principles and fundamental elements used in analyzing

> credit risk; rating factors; qualitative or quantitative assumptions used to arrive at a rating opinion (e.g.
> analytical adjustments to financial statement information, stress scenarios and loss
> curves used for projecting future losses on asset pools). (CESR Ref. 10-945, CESR Guidance)

All encompassing classifications only blur the very methodological distinctions necessary to instruct ESMA on how to identify 'reliable, relevant and quality' rating models (ESMA, 2011b/462, Art.4) – along with the 'objective' justifications which sanction their revision – without impinging on their analytical constitution. In the process, the EU must determine whether 'all driving factors deemed relevant' were actually incorporated into the assessment of sovereign creditworthiness. Unfortunately, such broad and nebulous requests make both compliance with the RTS and its regulation an arduous ordeal; one that ESMA is neither prepared for nor mandated to manage.

Conclusion

Closer supervisory convergence across Europe is thought to enhance EU regulation of the ratings space. The vast majority of the oversight responsibilities have been assigned to ESMA. Irrespective of the bold new initiatives proposed, I contend that they expose ESMA to supervisory conflicts which it wishes to avoid. Its ambition not to interfere with the analytical substance of the rating process risks being jeopardised on several occasions; especially in regards to sovereign bond ratings. First, when assessing new draft rating methodologies, either the current regulatory technical standards (RTS) (Article 8(3)) or the alternative principle-based industry standards will compel EU officials to exercise a great degree of informal judgement about contestable qualitative factors in rendering a decision. Such is the nature of fiscal relations that it does not readily lend itself to being captured through quantitative methods alone as risk calculations which only need to be recomputed. Contingent liabilities are evident in the evaluation of political factors and in how they configure into the construction of a credit score. Analytical interference is anticipated as an inexperienced ESMA probes this process with few clear definitions or guidelines.

Otherwise, if ESMA becomes disproportionately preoccupied with quantitative measures then it helps institutionalise a form of dysfunctional information exchange as it omits or distorts uncertain fiscal relations by adopting aggregating (risk) methods which impose an artificial fiscal normality on the heterogeneous European budgetary landscape. Acknowledging that 'while quantitative measures and models are useful in assessing credit risk', S&P (2010a: 4) does 'not believe they capture all the nuances of the real world, which can sometimes contradict the information exhibited in financial ratios or provided by a quantitative model'. For the sake of stability and quality, ESMA cannot rely primarily on this mode of verification. Qualitative interference seems inevitable as it assesses the process through which sovereign bond ratings are constructed.

Arguably, nowhere is this intrusion more precarious then in the EU's attempt to ensure stability by gauging the suitability of proposed revisions to rating models and assumptions. Stress tests implicit in these propriety models are a synthesis of informal judgement and statistical probabilities, which together help CRA committees validate competing proposition about sovereign creditworthiness. Secretive and opaque, the analytical configuration of ratings demands that ESMA scrutinise and somehow regulate what is a very fluid and contingent practice. In the process, ESMA may conflate these categories as it interprets their qualitative design and validation. A passive approach, however, can leave oversight susceptible to cooption as Moody's and S&P define the regulatory parameters as they deem fit.

As challenging as ensuring stability will be in the ratings space, this task risks being complicated by ESMA's concurrent responsibility of enhancing competition in the effort to break the oligopoly. Greater diversity increases the frequency of revisions which can infuse more volatility into the markets. EU funding for a European Network of Small and Medium-sized Rating Agencies also exposes it to conflicts of interest; without any guarantee that this initiative can dislodge Moody's or S&P from their perch. Because of its limited oversight experience, ESMA may again find itself intruding into the analytical substance of ratings as it seeks to strike a balance between stability and competition. These supervisory conflicts threaten to undermine ESMA's capacity to manage the ratings space effectively. Rather than reversing the tide of speculative attacks against beleaguered Member States, this framework, in fact, can make the EU more susceptible to destabilising effects.

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