

Europe Needs a Rating Agency

By Markus Krall

One of the key institutions in the capital markets, the credit rating industry, failed in the financial crisis – that much is beyond dispute. The decisive factors in that failure were the business models and roles played by the dominant agencies. They allowed the US real estate bubble to occur in the first place and further exacerbated the crisis. Regulation is only part of the solution.

Without the seal of approval of the credit rating agencies, the bubble in real estate could never have developed. The ratings – paid for by issuers – tempted investors and banks into accepting risky investments as being safe without questioning the securities' first-class creditworthiness. This division of responsibilities likewise made it possible and attractive for US mortgage banks to grant large numbers of loans without adequately inspecting the quality of the loans.

This misallocation was preceded by a series of institutional weak spots in the rating industry. The interplay of these weaknesses gave rise to considerable systemic risk, ultimately borne by the taxpayer.

Significant risks still present

While current steps towards stricter regulation of the rating industry do involve some good approaches, they are only capable of diffusing some of these risk factors. The issues of competition and remuneration models remain unaffected. The monopolistic rating agency structure needs to be abandoned, and a new business model introduced. This can only

be achieved if a European rating agency with global reach is able to establish itself in the markets. Its influence would have to be sufficiently great to be able to change the rules in this market by offering a new governance and remuneration model as an alternative to the systemically dysfunctional status quo. The agency should be incorporated as a foundation



and be afforded the greatest possible independence in order to avoid conflicts of interest. It should introduce a remuneration system for which investors are responsible, and which is exposed with the greatest possible transparency to the controlling effects of public scrutiny. This is the only way to create incentives for ratings of the highest quality. ■

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