Weakness of sovereign ratings

Will the agencies be accountable at last?

GEORGES UGEUX

For years, we have heard legitimate complaints about rating agencies. The most recent one comes from Hu Jin Tao, the Chinese President. He called the G20 to set up objective and sustainable criteria for sovereign ratings. A G20 working group, co-chaired by the governor of the Reserve Bank of India, called for more regulation and transparency.

Just before that, the Chinese rating agency, Dagong Global Credit, had sovereign ratings where the US, UK, Japan and, of course China, were AAA. In mid-July, the first three countries were downgraded to AA while China kept its AAA rating: the interesting part is that the arguments used by Dagong were difficult to refute. The Chinese agency considers that the public debt increase and the slow economic growth were making the service of the debt of those countries more difficult. It looks fairly objective, and it is supported by strong economic data.

On 25 August Standard & Poor's, following Moody's, downgraded Ireland. The argument was that support to the banks by the government might increase from €35 million to €50 million. The Irish Treasury responded by saying that it is the worst case scenario. It raised heated discussions.

The recent upgrading of India is certainly welcome. However, the justification is based on four elements: economic, institutional, government financial strength and low risk of event. This is a perfect example of the issue facing these ratings: they are allocated to sovereign bonds issued in foreign currency. One would expect that rating agencies would focus on foreign public debt and the risk of default of this debt. It is only one consideration and does not seem to recognise that there is very little foreign currency sovereign debt issued by India.

In Istanbul, during the IMF-World Bank meet in 2009, Prime Minister Erdogan launched a diatribe against his country's rating. The amplification of these rating movements by the media and their exploitation for political benefit are compounded by the judgmental declarations of sovereign rating executives. They forget that they have no right to pass summary and broad judgments, let alone get involved in elections and government formations.

The egos behind those statements are not very reassuring on the objectivity of the ratings. Actually, as we have seen in the case of European countries, they are particularly violent when the downgrading happens too late. Greece was a perfect example.

There is an imbedded colonialist view of emerging markets in sovereign ratings. The majority of emerging markets are rated below A while the majority of "Western" countries are rated A or higher. There is (of course) no AAA-rated emerging country.

In addition, the dogma according to which companies cannot have a rating superior to their country rating creates serious imbalances. TCS, with almost no debt, is BBB+ while Accenture enjoys an A+. The only reason there is such a difference is the fact that TCS is Indian and Accenture is American. The shares of TCS increased by 20 per cent since the beginning of the year; Accenture's decreased by 13 per cent. Where is the fairness?

This is an uneven treatment of countries and corporate debts. It does have huge consequences: in its recent EIB (European Investment Bank) financing, Jaguar Land Rover could receive its EIB £340 million financing with the sole guarantee of the State Bank of India who does not enjoy an A rating. It needed to add a syndicate of at least A rated banks. The cost of this additional guarantee doubled the spread paid by Jaguar Land Rover. No Tata entity has a rating above BBB for the same reasons.

The Dodd-Frank Act has made rating agencies accountable: this is a brave new world. For the first time, interested parties will actually be able to sue rating agencies. This "private right of action" sent thrilling messages to the agencies. They announced that their ratings could no longer be published for a period of three months during which they will "assess their new legal liability". As a result of that action, the US Securities and Exchange Commission (SEC) had to grant issuers exemptions to obtain and publish their ratings.

Accountability, even if it is restricted, will require more care and sense of responsibility from rating agencies. They pay dearly for their corrupt ratings of securitised products. They can only blame themselves. In the long run, they will survive and flourish if they are willing to fundamentally reform themselves. ◆

The author is chairman and CEO of Galileo Global Advisors in New York and former head of international of the NYSE