



# HOUSE OF LORDS

Unrevised transcript of evidence taken before

## **The Select Committee on the European Union**

Economic and Financial Affairs and International Trade (Sub-Committee A)

Inquiry on

### **CREDIT RATING AGENCIES**

*Evidence Session No. 2. Heard in Public. Questions 44 - 67*

TUESDAY 24 MAY 2011

11 am

Witness: Dr Adrian Blundell-Wignall

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Members present

Lord Harrison (Chairman)  
Lord Hamilton of Epsom  
Lord Haskins  
Baroness Hooper  
Lord Jordan  
Lord Kerr of Kinlochard  
Baroness Maddock  
Lord Marlesford  
Lord Moser  
Lord Trefgarne  
Lord Vallance of Tummel

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**Examination of Witness**

**Dr Adrian Blundell-Wignall**, [Deputy Director in the Directorate for Financial and Enterprise Affairs, and Special Advisor to the Secretary-General on Financial Markets, OECD].

**Q44 The Chairman:** We are awfully grateful to you for appearing before the Committee today in our second session of witness-taking on the credit rating agencies. We are most grateful for you stepping in. We will be doing a transcript of all that takes place this morning, which we will send to you. We hope that you will be able to correct it if there are any misunderstandings or any clarifications that you would like to make, so that we can get the best of the information from you. Additionally, at the end of the session you may think that there are other items that you want to add for the purpose of helping the Committee understand the credit rating agencies better. Feel free to communicate with us; we would be most grateful. Are you happy to start?

**Dr Adrian Blundell-Wignall:** Yes. I have a set of 12 questions that I had a look at before. Are you going to follow those?

**Q45 The Chairman:** We will more or less follow that order, if we may. The first question is whether you think that the credit rating agencies played any kind of role in the

euro area crisis, and whether you think that they exacerbated matters. Can you still hear me?

**Dr Adrian Blundell-Wignall:** I can hear you but I cannot see you at the moment.

**The Chairman:** Well, I am not a pretty sight.

**Dr Adrian Blundell-Wignall:** You are back.

**The Chairman:** We have got you. Would you like that question again? Did the credit rating agencies play any role in the recent euro area crisis and, if there was a role, did it exacerbate matters?

**Dr Adrian Blundell-Wignall:** I know that people say that, but to me the issues in Europe are fundamental and home-grown. As to whether they exacerbated matters, it is a bit like they are saying that the agencies were pre-emptive in calling downgrades and were somehow unfair, whereas in my view if there was a problem with the credit agencies it was that they were a bit late in downgrading—they tended to follow rather than lead the process. I guess that my overall answer to the question is that they did not exacerbate the process. The spreads blew out first and the credit rating agencies tended to lag a bit behind, playing catch-up. It is hard for me to imagine that they exacerbated the process.

However, as I say, that is not the usual interpretation. Usually when people here complain, they say that these bad credit rating agencies came along, did these downgrades that they did not have accurate information for and caused a problem when there was not one. Believe me, there is really a problem here in Europe; it is a big problem and fundamental in its nature. If anything, the credit rating agencies have been behind the curve a little bit.

**Q46 Lord Hamilton of Epsom:** You have almost answered the question that I was going to ask. It sounds to me that if you are taking that view, we should not really be talking about doing anything about the credit rating agencies. What you seem to be saying is that

the issues within Europe are fundamental and the agencies are incidental to all this—they do not really have a great role to play. Am I misinterpreting you?

**Dr Adrian Blundell-Wignall:** It would have been better for the credit rating agencies to be more prescient, and they have made a lot of attempts to improve their models. There is a huge role for credit rating agencies throughout Europe in many different ways. Everyone uses them—everyone has to use them—and when they are not working properly, that inefficiency leads to problems. For example, it can lead to investors losing money because they are working off ratings that are inappropriate. There is a role for reform, but as to whether the agencies exacerbated the crisis, the crisis itself is fundamental in nature.

The agencies definitely need to have a better model. There are competition problems and other issues. I guess you all know what credit ratings are used for. They are used in the Basle system for banks, for example, which is very important. They are used by fund managers of pension funds who have to set benchmarks and apply credit ratings where they are not allowed to buy less than a certain credit rating, and so on. They are written into covenants, bond contracts and so on. They play an important role and they go through many things. There are ways in which they can cause problems for people. For example, when a credit rating agency downgrades below a certain level, that can lead to cliff-edge effects. There are a lot of things that need to be reformed. I thought that this was a good set of questions. I do not know that we should be saying that there is no question to answer; there are a lot of questions about reform in the credit rating agencies. I did not regard the first question as saying that there is no need to reform them, only that the crisis was not caused by them.

**The Chairman:** Let us move on to the reform.

**Q47 Lord Hamilton of Epsom:** Let us pursue that. If you are talking about reforming the credit rating agencies, how externally can that be done? To come back to the question of whether they were lagging behind the market, they had to make political decisions about

sovereign debt in Europe and the political decisions that they made were the same as those of everyone else who was buying sovereign debt—namely, that across the eurozone it was underwritten by the Germans and the French so it was not very high-risk. When it then became clear that it was possible that sovereign debt might see defaults in the peripheral countries, the rating had to change massively. How do you see it being possible for any external organisation to reform the credit rating agencies? I do not see how they would happen. They will have to reform internally, won't they? They will have to sort themselves out; I do not see how anyone can do it for them.

**Dr Adrian Blundell-Wignall:** The arguments about the credit rating agencies are really about the structure of the industry. Internal reform is one thing, but the most basic problem with the agencies is, first, the oligopolistic structure that they have and, secondly, the “issuer pays” approach. All these things are treatable by reform. In the “issuer pays” case, as you know, the problem is there is incredible moral hazard. Say that you have been working with CitiGroup for many years and it is putting out a new issue of something or a Government. There is incredible pressure on you to give it the rating that it wants because if you do not then its spreads will be higher. Governments can save money by having lower spreads, so there is pressure. If someone is applying for a job, you probably should not be taking a reference from the person's father, and it is a bit like that. There is a close relationship, and should you be taking a reference from someone who has such a relationship with that firm, or is there a better way to organise the industry?

**Q48 The Chairman:** The phrase for that is “downgrade rigidity”, in the sense that they are loath to reduce the credit rating of a sovereign that pays them. Could that be reformed?

**Dr Adrian Blundell-Wignall:** I think so. One of the basic problems there is whether you can address the issue of oligopoly and competition. There are only three major players in the ratings business. One of your questions asks whether there is a natural oligopoly, and to

some extent there is. A credit rating product is what you could call an experience product. It is not very objective. A firm builds up a reputation over a long period of time, for better or worse, and that experience product is the nature of it. It is hard for a new person to come in and say, “Hey, look at me, I’m a pretty good company, I’ve got a good model to do all this as well”, because people then need to spend a lot of time on it.

What are they trying to do? They are trying to give you comparability so that this Greek Government bond is comparable to that one because they have the same rating. People all over the world who buy these things need to be able to have a comparable standard.

**Q49 Lord Vallance of Tummel:** You mentioned the point that this could be a natural oligopoly—the jury is out, but it could be. If it were, the question arises of what regulators should do about it. Do you regulate it vigorously, because that is the only move that you can make, or do you try to attack the barriers to entry and have more competitive players on the field. Which route would you go down?

**Dr Adrian Blundell-Wignall:** When you think about what the requirements of a good credit rating system would be, it is obvious that investors need to have confidence that they have a comparable standard between products that is easy to interpret and understand. I am thinking about the issues that would reduce oligopoly, maintain the comparability and encourage a bit of competition. You are trying to do a number of things simultaneously so whatever you choose to do should maintain the comparability of credit ratings, improve competition in credit ratings and remove the moral hazard problem that comes because the “issuer pays” principle is too close to the issuer. I will put out on the table what I think: if I were to have my ideal system, the first thing to do would be to have just one set of ratings like double A, triple A and so on—I am using the S&P version, but every agency has its own variant, which immediately ruins comparability—for all things, and all credit rating agencies would have to provide those ratings using the same letter.

The second thing would be to try to address the “investor pays” issue. There the matter is simple: you could make a regulation that said the investor has to somehow pay for due diligence. This process used to work until recent years. If Moody’s or S&P says that it is a triple A rating, a BB rating or whatever it is, they have used certain information provided to them by the Government concerned, or the company if it is a private rating. You need to make the investor, not the issuer, pay for some due diligence on that. Yes, you can take a rating offered by the issuer payers, but then the investor should have a regulation saying that by law you have to have some due diligence company where there can be no collusion—collusion is prohibited by law—and you have to pay for due diligence on the input. That requires that the Government or the company wanting to issue a security have to provide exactly the same information that they provide to the credit rating agency to the due diligence companies as well. Then the due diligence company checks on the truthfulness or the completeness of the information. That way there is then some pressure on the credit rater not just to give a friendly credit rating.

Thirdly, on how credit ratings are allocated, I am in favour of the idea of what some call the “platform pays” model, where—this could be a way to do it; I was just talking about it with regard to due diligence—the investors had to pay a fee, a bit like an insurance fee or something, and a Government-sponsored agency then allocates the credit rating agency to the issuer. In other words, it could say to a particular country or company, whatever it was, “The person or group that had the best proven record of historical performance, being prescient and so on, we are going to allocate them to you”, so it is not a question of people getting together. The issuer cannot just choose his own credit rating agency but gets allocated one by a platform.

**The Chairman:** That is very helpful. Does Lord Vallance want to follow those suggestions up?

**Q50 Lord Vallance of Tummel:** What you have been saying, in a way, is that you have more interventionist regulation of one kind or another. Let us just come back to the number of players in the game. Why do you think, given that there are a significant number of private sector EU-based players, that none of them have ever made it to the top table?

**Dr Adrian Blundell-Wignall:** You mean, why is it always the top three that end up being the main raters?

**Q51 Lord Vallance of Tummel:** Yes. There are all sorts of potential competitors in Europe; they even have a trade association. Why do you think none of them have made it to the top?

**Dr Adrian Blundell-Wignall:** First of all, the barriers to entry are a problem. Credit rating is an experience good, and if you do not already have the relationship then it is hard. One of the main barriers to entry, as I am sure you are aware, is that there are explicit mentions in some of the regulations of the ratings that you should have. Those regulations essentially give you a Government stamp of approval; you must use these agencies. New players are not written into the regulations, which makes it hard for them to enter into the process. That is why I mentioned that if you had a set of ratings that everyone had to use, regardless of which company you were, and the other reforms then you could get away from that. Those are some of the reasons regarding the smaller players.

The way that regulations have gone in Europe has been costly, in some sense. For example, there are a lot of Asian-based rating firms that could easily be involved in the process of rating within Europe. The fairly onerous registration requirements, endorsement requirements and local presence requirement—you actually have to have an office in the country concerned, or something—make it very costly. It is a question of the barriers to entry, and the fact that people do not have long track records and this relationship-based way of doing it makes for a natural oligopoly which makes it hard for new players.



The new players, the small groups, can get in to do things that are not really the mainstream—small companies and things like that where the bigger companies are not that interested. There is a missing piece of the market and the small groups tend to get in there, but not into where you need these reputational things where the costs are high and so on.

**Q52 Lord Haskins:** Is there not a possibility that this is all a bit academic? The credit rating agencies have built up their trust with their customers. Businesses have used them and relied on them for 40 years. Has that trust been broken and damaged very badly by events, particularly in private sector debt and sovereign debt? How will that reputation be restored? People do not trust them any more.

**Dr Adrian Blundell-Wignall:** That is a fair comment. We at the OECD had S&P come in recently and spend a day with us going through how they propose to reform the way that they do credit ratings and to improve the model of it. That sort of thing can be encouraged. It was a pretty technical discussion, and some of the issues that they are trying to deal with come up in some of the answers to some of your questions. They are trying to deal with some of the issues around, if you put aside the moral hazard issues and so on, to what extent the process was due to the methodology that they were using. When you talk about inflated ratings, that is telling you, and there is some evidence of this, that those firms actually—

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**Q53 Lord Marlesford:** How would you assess the relative experience and skills of the IMF and the OECD in assessing the sustainability of sovereign debt? By “sustainability” I mean the ability of the countries concerned to service their loans and eventually to repay and/or refinance them.

**Dr Adrian Blundell-Wignall:** The answer to that is “excellent”. I have written some papers on this, which requires you to do a lot of modelling and so on of the issues. The ability of

the IMF and the OECD is very good. The only comment that I would make, and I am not trying to plug the OECD in particular, is that the issue with the IMF is that you could argue there is a bit of moral hazard there because it is involved in providing programmes to the EU, in which case it could be tempted to err on the side of optimism with some of these countries because not to do so might increase the problem and the amount of money that they had to deal with. There is a bit of an issue there—you should really be independent of the process to be seen to be doing a fair job. I am not saying that the IMF would not do a fair job, but at least you should raise the question.

Within Europe the OECD would be fine because we cover all the European countries, pretty much—not that it really matters—but the OECD has 33 members, which is not the whole world, while the IMF has the whole world so it could do that for everyone. On the other hand, it is not independent of the process when it comes to the financial side.

**Q54 Lord Marlesford:** Between the IMF and the OECD, which of you first realised that Greece had concealed a great deal of the information needed to assess the viability of its sovereign debt?

**Dr Adrian Blundell-Wignall:** When it came to the way that Greece was using certain structurings—it was using a private investment bank, for example, and was structuring things in a certain way to disguise things—I do not think that anyone was aware. It is difficult to be aware of things like the size of the sovereign debt. When it came to all the other issues, such as GDP, growth, tax and these kinds of things, both organisations were very aware that major problems were building up. In terms of the financial engineering that went on early on in the process, though, I do not think that anyone really picked that up very easily.

**Q55 The Chairman:** You mentioned before that S&P had come in to consult you about altering the way that it does its work. Could the OECD itself, or indeed the IMF, provide credit ratings?

**Dr Adrian Blundell-Wignall:** No, I do not think so. When I made those recommendations to you earlier, I thought quite carefully about practicalities. You have to continue to work with the credit rating agencies. There is a puzzle here, in a way. Stocks, equities, are analysed; all these big investment banks around the world analyse stocks and put a buy, a hold, a sell on them. But for whatever historical reasons—

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The stocks are analysed and the securities are rated. If you think you know what goes into a rating, I do not know if you are interested but I can give you a little rundown about how S&P does it, and it has to do that analysing and rating for every single stock and company in the world. The resources required to do this are enormous; they are all like huge investment banks that analyse securities. Hundreds of people are involved in doing this. That amount of detail goes into the ratings that S&P does, which I am familiar with because, as I say, they came in and consulted with us, showing us what they do and asking for comments on it.

**Q56 The Chairman:** Were you able to comment and make some recommendations? What were they?

**Dr Adrian Blundell-Wignall:** I will summarise briefly what S&P does. It has a scoring system. It has five categories of things that it scores. The first category is the political score. Essentially it is looking at the effectiveness of political institutions, political risk and so on. The second category that it looks at is economic structure and growth prospects. The third category is external liquidity and international investment position. The fourth category is fiscal flexibility, which is about fiscal performance debt—the question that we talked about a moment ago. The fifth category that it looks at is funding and monetary policy flexibility. It looks at those five things and then gives a score, which usually goes in a rating of one half, one, one and a half, two and so on up to six, where one is good and six is very bad.

For the political score, it considers whether you have proactive policy, whether you manage crises, whether you deliver growth, whether you have an ability to implement reforms. If the country in question were the UK, S&P would look at your country historically and ask, “Were you able to implement reforms? What sort of extensive checks and balances do you have? What sort of information flows and policy debate do you have? Do you have timely data?”. It looks at all that and then give you a score from one to six for political. For economic, S&P does a similar thing: it looks at your medium-term growth prospects and gives you a score between, again, one and six for that.

Then—I want you to think about this—S&P gives you a score for each of those things and averages that. Then it gets on to the external score. It looks at the ratio of debt to GDP, the external financing needs of the country and gives you a score. It keeps doing this, and the main criticism that we had was about what we call the “linearity bias”. Basically, of the hundreds of things that they give you a score on, what weight do you attach to each one of those things? For example, it might be extremely important in the case of Greece that one of those categories is the driving factor, but if you have averaged it with about 65 different things, you end up getting a score that does not make it timely. That is the issue.

**The Chairman:** I could not agree with you more.

**Q57 Lord Moser:** I want to pursue the question of methodology, especially to hear how happy you at the OECD are with the evolving methodology. It seems that in the past the managers of a particular agency have sat around a table, decided on a few obvious indicators—GNP, employment, fiscal indicators, whatever; maybe some political indicators as well—and then someone says, “Well, it looks like a triple A”, and someone else says, “Actually, that’s giving too much weight to employment”, and so on, ending up with a multiple opinion. That does not give me very much confidence in the way that the agencies

have been working. I wonder how you have felt about that and how the future reforms of methodology should make one more confident.

**Dr Adrian Blundell-Wignall:** That is a good question. The methodology of scoring has the problem that I just referred to, of the average of the average of the average—the linearity bias that ends up not giving the weight to the most important things. I do not know how to deal with the problem of methodology. The agencies deal with it by going through the mechanical process of scoring and then coming up with what they call an indicative rating, which can then have a negative or positive adjustment factor. With the debt burden, for example, they might go through the scoring process about the debt-to-GDP, the cost of interest and so on and then give a score—from one to six, in the case of S&P. Then they might say, “But if we have a look at this, the IMF has just given them a package, they will have to refinance it by 2012 and go back to the market so there is a refinancing risk, so”—just as you were saying—“we’ll give them a qualitative override, a negative doubt. The model says triple B; we’ll go to triple B minus or double C or something like that because of this refinancing risk, which is not really in the model but which is a current issue”.

That degree of arbitrariness is a concern. We did research during the crisis. We looked at what the models were saying and the ratings that the firms were actually giving, there was a big difference between what the model said and what the ratings were. In the run-up to the crisis, the ratings were inflated compared to what the model was saying; they were too good. Even now, those reforms are trying to improve the indicative rating and to give much more guidance about the conditions in which they would make an ad hoc adjustment to that, based on special factors.

**Q58 Lord Haskins:** You remark that the model was showing more pessimistic views than the ratings. That is a pretty serious situation. How did that arise?

**Dr Adrian Blundell-Wignall:** This was mainly to do not with sovereign debt but with structured products with regard to mortgage-backed securities and things like that. To be fair to the rating agencies, the problems that there have been with sovereign have been less than there were with these private mortgage-backed securities, residential mortgage-backed securities, collateralised debt obligations and the like. There was massive evidence of grade inflation, and that has been the moral hazard problem—this is exactly what I was talking about before—where the credit rating agency has been too close to the issuer. In the case of the private sector, they want a good issue because they want people to buy it. If you tell people that it is junk, no one will buy it; if you tell them it is triple A, then people will buy it. With sovereigns it is a case of, “Listen, if you give us a triple C on our ability to repay this debt, then it’s going to be a huge spread for us. It will be very costly for our country and we don’t want you to do that. We won’t give you the job; we’ll look somewhere else”. This is why in the recommendations that I made at the beginning I said that we have to find ways to do this. That problem will never be solved until you can find some way to make a break between the issuer and the rater.

There is a problem with supervision in sovereign debt. Just imagine it at the moment. There is a good question here on the list about this European proposal to have its own Government-sponsored credit rating agency and why Germany is so keen on that.

**Q59 Lord Kerr of Kinlochard:** I understand your strong point about moral hazard, but not your moral hazard solution. You say that the buyer should be the payer of the credit rating agencies. That would mean some sort of transaction tax, presumably. In addition, surely you would have to ban the issuer from paying. That would require some sort of supervision and enforcement as well. How do you make your solution to the moral hazard problem, which I can see is very real, work?

**Dr Adrian Blundell-Wignall:** Let me reclarify what I said before. You can still work with the “issuer pays” principle. The issuer pays S&P to do a credit rating for a sovereign or a private sector security, but the two things that I am proposing break that link. The first is that a platform, or a quasi-governmental agency, assigns you the credit rating agency that is going to do your rating for you. You do not have the choice to say, “I’ve always worked with S&P, they’ve always been very good to use”. No. The government agency will say, “Actually, this smaller European outfit has a much better record than S&P so we’re allocating this group to you”, and it would have to use the standard rating methodology that I described. The second is that the investor—this used to work in some ways before—should be contributing by paying due diligence companies. With credit ratings it is a case of garbage in, garbage out. If you put garbage into the model then, regardless of any ad hoc adjustments that you might do afterwards, you will get garbage out. The investor should have a legal requirement to say, “We have done due diligence on this”—not just the investor themselves, because they do not have the expertise; they are obliged to pay a due diligence company to look at the rating and at the information that was provided to inform that rating and say, “Yes, we’ve looked at their model and their data, and this is what comes out of it. It seems to us to be a fair rating”, or, “No, this model when we score it does not come out with that answer”, or, “They haven’t used the information that we would have used. There is missing information here”, or, “The information that they’ve given doesn’t appear to us to be true”. For me, those things drive a wedge between the issuer and the credit rating agency and stop the two being too close.

**Q60 Baroness Hooper:** Do you agree with the criticism that the three major rating agencies have an Anglo-Saxon bias—that because their roots are in the United States they do not truly understand the way in which the European economies are constructed? We understand that this criticism comes mainly from Germany. Do you agree with it?

**Dr Adrian Blundell-Wignall:** Objectively, that is true for two of the three companies but not for the third. The first one, Moody's, is owned by Warren Buffett, basically—Berkshire Hathaway is an American company—while S&P is owned by McGraw-Hill, which is also an Anglo-Saxon company, but Fitch is owned by Filmac, which is a French property group, so it is not completely true.

With regard to the EU, is now an appropriate time to make my comment on Germany?

**The Chairman:** Yes, please do.

**Dr Adrian Blundell-Wignall:** The question was: as the CRAs grew up in the US, they do not understand Europe—do I agree? Certainly not. I did not grow up in Europe either, and I have written papers on the European debt crisis; indeed, I think that you could be in Antarctica and have the information and do all the research that you would need. That is not a very wise point. I have a problem with Europe. I am not really talking about your country; you are an Anglo-Saxon country and there are certain standards of transparency that have grown up over very many years, but on the Continent of Europe that is not true. This is a very untransparent place, which is why you find out things about banks, Governments and problems way after the event. Let me tell you, I sit as the OECD representative on the Financial Stability Board, and I see first-hand all the time the extent of what is going on behind the scenes and in the public domain. So I do not agree at all.

Why is Germany so in the lead on all this? Behind all this is the fact that Germany has the biggest purse in Europe and the biggest weight in any payment, but there are three important points here. First, when it comes to sovereign debt, if there were to be any restructuring of that debt, which is what everyone is talking about at the moment—reprofiling, restructuring, all these things—remember, as in the case of Greece, who holds the bulk of those sovereigns that have been bought in the open market in the past couple of years. The European Central Bank is holding all this stuff. If you restructure all that debt, the



ECB will basically lose a huge amount, possibly to the extent that the whole bank would have to be recapitalised. Germany would have to pay for that and it does not want to have to. If the agencies downgraded the minimum category that the ECB can use for collateral for carrying out its operations to buy and work in the market, the same thing would happen and there would be a real problem for the ECB. Germany sees that as something that it has a contingent liability for.

I will make the second point for you, and you can do whatever you want with it. When you think about the solutions for the European sovereign debt crisis—we know the four main countries that we are talking about here—there are really only two solutions and then a third thing that will happen if you do not go with either of those two solutions. The first solution is a major restructuring, but that has the problem that it would really hurt the capital of the ECB—essentially, the ex-Bundesbank guys, who still have a big role, so Germany would have to play a real part of recapitalising that. The second solution is what I call mutualisation of the problem—that is, that Europe as a whole has to pay. Basically, the country is not going to restructure because of all the problems that it would cause for the banks and the ECB, but mutualisation means that in the end the Governments have to pay.

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I was just saying that in both cases, whether restructuring or mutualisation, Germany would have to pay. Unfortunately, if you do not do either of those two things, the third outcome is a descent into what I would call disorderly restructuring—that is, over the next few years things will just get worse and worse, in the end the markets will force it and it will be an even bigger problem. To me, shooting the messenger here is not really the solution. We should be reforming and not worrying about whether the agencies are European or not. In my view, given the moral hazard problems of what is going on in Europe, it would be very dangerous right now to support the idea that the European Government would set up their

own credit rating agency. Heavens above, what credit rating would it give? It would revise Greece and everyone else up to investment grade or something, because of this moral hazard issue. You do not want to do that. I am dead against it. You should definitely not have a new European-based Government-sponsored credit rating agency to compete with these private firms; that would be a huge mistake and would probably make things worse. I am speaking frankly now.

**The Chairman:** I think that that polishes off that particular question.

**Q61 Baroness Hooper:** Thank you, that was very clear. Do you agree with the view that credit rating agencies provide an essential public service, and that therefore there is an obligation to have regulation, as for other public utilities?

**Dr Adrian Blundell-Wignall:** Absolutely. The only way to manage an oligopoly, which we are going to be working with, is to regulate it appropriately. It is like when you have a broadband network for a country and then the providers of inputs into that network. If you have a complete monopoly or oligopoly owning the broadband network, you have to regulate the terms and conditions under which the providers can gain access.

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**The Chairman:** Mr Blundell-Wignall, you are back again. I am going to ask Lord Jordan to follow up your very interesting train of thought.

**Q62 Lord Jordan:** You have been giving us a good insight into many of the problems and then demolishing most of the solutions that we have been thinking about. We have seen the effect that these ratings can have on member states and their ability to raise finance. How can Governments curtail or restrain the independent natural oligopoly that you describe, when literally their word is law? As you have told us, these same Governments are actually writing into their regulations that they must follow these agencies. What practical steps can be taken to reduce their power over what is happening in the financial markets?

**Dr Adrian Blundell-Wignall:** I said before that we should just have one set of ratings, like triple A, double A and so on, so that everyone, whether it be Fitch, S&P, Moody's or some smaller outfit, would have to use the same ratings so that we did not have a brand name associated with them and triple A did not mean S&P any more but meant that anyone who did a rating had to use the same system. I would like that. I do not know whether that is possible or not. You would not have comparability problems, such as asking, "What is the equivalent Moody's rating to an S&P triple A?", or, "What is the Fitch rating?", and smaller firms would not have to choose some other metric otherwise S&P would sue them because they were using its terminology. For me, having a single terminology for what ratings were would be a first step—hopefully, that is possible.

The second step, which goes to the heart of breaking the "issuer pays" model, is to have due diligence. Basically, you say that henceforth, as a regulation, if you buy a sovereign security or any security that is rated, you have to go through due diligence, which means X, Y and Z—that is, you have to hire a due diligence company to check this thing. That puts pressure on the rating agency; suddenly it cannot give you an inflated rating or whatever because there is going to be an independent check. Collusion, just like collusion for resale price maintenance or something, would be excluded if you knew that by law you would not be allowed to collude with the company. The issuer would have to give the due diligence company the same information that it gave the ratings company. The due diligence company would look at that and say, "Yep, this is kosher information and yes, they've used it in the way that they say they have; we give this a tick", or, "No, this looks dodgy to us; there's missing information". To me, those things would still allow for working with the reputations, the expertise and the staff that these groups have.

Regulations have already addressed some of this. We have already stopped the internal conflict of interest—

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**Q63 Lord Jordan:** On the first suggestion, it seems that in the present circumstances common terminology would actually enhance the agencies' power because it is still them and whatever they said. What steps could be taken to lower the reliance on their power?

**Dr Adrian Blundell-Wignall:** That is a bit unfair to what I was saying. One of the things that the agencies rely on is this brand name recognition. If a small rating agency could use triple A ratings and that was not interpreted as an S&P rating any more, that would already start to break down the brand name that S&P has. Whatever the source of the oligopoly, it is about reputation, brand names and this kind of thing.

The other thing that I recommended, you might remember, was the "platform pays" idea; I think it is important. It means that if you were an issuer, you would apply to that Government-sponsored group and say, "We want to issue this product", and they would say, "We will give you the rating agency that will rate your product". You would not have the ability to choose it yourself. That group could start giving those ratings to smaller companies. You could say, "Actually, this company has always done a good job on this; we are going to allocate you this company".

Of course, S&P, Moody's and Warren Buffett will hate this. Warren Buffett is a very smart investor; the reason why he bought Moody's was that it is a brilliant business model, sort of like a global oligopoly—people are forced to use it. I am saying, "OK, let's have a little break from that". We do not have to use Moody's. You might not get Moody's. You will not have the ability to choose Moody's. We are going to allocate you with a company, which might be Moody's, S&P or some completely other player—from Australia; why not? However, it is not practical to say, "Let's get rid of them". You probably have a pension somewhere in the world and your pension fund will have things like a certain risk tolerance for a particular investor, so it would not go below investment-grade securities. You have to have some way

of saying, “These are investment-grade securities and those are junk”. If you do not want to have junk in your pension portfolio, you should know what those securities are. So we need the credit ratings. On the other hand, you need to break the oligopoly, which I think the “platform pays” model does.

**Lord Vallance of Tummel:** You have put your finger on it—this is a global oligopoly. If we are going to control it, the thesis is that there needs to be a fair amount of intervention, and you have given a lot of examples of what that intervention might be. If it is a global oligopoly, though, where should the regulator sit? Who is best placed to regulate it, or should we have a multiplicity of national and regional regulators, as now? Is this a role that could be undertaken by the IMF or the OECD?

**Dr Adrian Blundell-Wignall:** That is a good question. The group that I sit on, the Financial Stability Board, is precisely set up to try to improve the consistency of regulations—more than credit ratings, generally speaking. That would be the forum. It would not be the OECD or the IMF; they both have a seat on the board, but also on the board are the national regulators for financial firms. The groups that would be best suited would be IOSCO and the Financial Stability Board; they are the groups that you would look at to try to co-ordinate the regulations. It is all very well for America to have this, Europe to have this, the UK to have that and Australia to have another, but at the end of the day people always do regulatory arbitrage; they say, “If it’s less onerous to issue in America or Australia than it is in Europe, let’s just issue there because anyone can buy these things globally”. You need to have it such that people cannot just move around. I said before that if ratings are anything, they have to be comparable. If you are sitting in the UK and you want to buy American or Australian treasuries, you should have a way to compare that to a French or a Greek treasury. That should be consistent and clear to you. The regulations need to be consistent

and the same across countries. That is hard to achieve, but then it is hard to achieve in everything.

**Q64 Lord Trefgarne:** I would like to examine the difference between sovereign debt and what they call private debt and how they might be separately regulated if you think that is appropriate. Some academics have suggested that sovereign ratings should indeed be exempt from regulation altogether. What is your view on how we should distinguish between the two kinds of ratings in this area?

**Dr Adrian Blundell-Wignall:** I thought that that was one of the questions on your list. I put down in the margin, “No, I don’t think they should be separate”. This is the comparability point again. Unless you are going to ban the private sector from holding sovereign securities or something, if I hold a portfolio in my pension or my company or whatever, I should be able to hold a portfolio of sovereign securities and corporate securities and I want them to be comparably compared. If there were to be a separate set of regulations and separate rating processes for the two types, I would not know what I was looking at because the moral hazards and so on that might arise in both of those could end up leading me to look at things that were misleading. The key thing is that you need an absolute standard that is comparable across countries, jurisdictions and products, and that should include sovereign and corporate. I do not see any basis to do different, unless you are going to start quarantining who can buy them and say, “OK, only pension funds can buy them”. No, I do not think that that is appropriate.

**Q65 Lord Haskins:** You covered a number of regulatory proposals earlier, but the two that you have not yet covered are the issue of the use of rating triggers in a lot of pension funds and so on, which can themselves create their own momentum in the way that ratings drop away, and the Commission’s suggestion for a three-day breathing space as opposed to

the present 12 hours, which the credit rating agencies told us was totally unnecessary. Could you comment on both those ideas?

**Dr Adrian Blundell-Wignall:** On the question of cliff effects, I have a lot of problems with the history of credit rating agencies thorough the crisis and so on, but it is hard to say that the cliff effects are their fault. If you build a cliff effect into your pension fund, or you are the ECB and you build in a cliff effect for what you can hold as collateral and what you cannot, you have done that to yourself—you have stuck the viper to your own breast. That is not really the fault of the credit rating agencies; it is a fact of how they are used. We should be trying to focus more on the question of quality and a good ratings experience so that people can be confident.

The problem is where you have bought, say, a residential mortgage-backed collateralised debt obligation and it was called triple A, and then overnight the credit rating agency downgrades it 15 points, which cuts right through your cliff effect, because the company had such a crummy model and/or it misused their own model to gain favour with the rater because of the fees that it would be paid for it. That is what we have to focus on.

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**Q66 The Chairman:** You are back with us.

**Dr Adrian Blundell-Wignall:** I do not know if the problem is with OECD technology or House of Lords technology, but there seem to be a lot of dropouts here.

**Q67 The Chairman:** We will call an end to this session now. I would like to thank you, not only for your answers and for their quality but for your enormous patience in dealing with the world of technology as it stretches right round the earth from London to Paris, which is not that far these days. We are so grateful to you. As I said at the beginning of the session, we will send you a transcript. Please correct it or amend it if it needs to be amended. If there are further ideas—there were certainly a number of interesting ideas that

you came forward with—please let us know. Perhaps we do not have time now to ask a question about how you would synchronise the triple A when you cut it off from S&P so that it had true worth across all the CRAs. Do you have any further thoughts? You were at least beginning to outline some possible solutions to the problem that we perceive.

**Dr Adrian Blundell-Wignall:** I shall say one last thing. If I were in your shoes, I would be thinking, “We in the UK are not going to change the way that the whole world does this, and we are not going to be able to change S&P’s models or anything like that”. What an individual country can do, though, is to take one of the elements of reform that I mentioned before and say, “Well, we have to work at the slow speed with which reform happens in this area all around the world, but there is no reason why in the UK we cannot require this due diligence point”. You do not have to reform the rest of the world; you can say, “For UK-based investors we now require due diligence and that is going to be a formal requirement”.

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“We have to work with this imperfect system for the moment. We will do our best to improve and comment on things abroad regarding global reform, but we can at least require UK investors to look at this due diligence point”. That is something that you can do, and it is practical.

**The Chairman:** I repeat: you have been so helpful. We will mull over all that you have said. Please communicate to us if there is anything further. In the mean time, before we are cut off yet again, I renew the thanks of my Committee to say that we are very grateful to you for appearing this morning. Many thanks indeed.