

COMMENT

Letters

Problem with the rating agencies is how they are used

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From Prof Eric De Keuleneer.

Sir, You are right to stress the need to discuss a fundamental change in the rating agencies' model ("[Tough new era takes a toll on rating agencies](#)", June 11). But the problem with rating agencies is not so much how they work or whether they can be improved (if at all), or their nationality as some Europeans seem to believe, but the way they are being used.

The widespread use of ratings issued by a few rating agencies enjoying a regulatory-blessed legitimacy has greatly concentrated the credit decision process, to the point that it came to look rather like a soviet-style, centrally planned one. Yet we know that a market system based on a multitude of decisions, with plenty of trials and errors, mistakes and successes, will produce a better allocation of capital than a centrally planned mechanism, where a few "experts" make all decisions. The latter may look attractive in theory but fails in practice. In fact experts routinely make bad decisions, because they can be wrong and they can be corrupted, and bad decisions applied globally then lead to massive misallocation of capital and dramatic failures.

The exaggerated use of ratings amounts to an outsourcing (without quality control) of the credit decision-making process, one of the major functions and social values of banks and institutional investors. By so concentrating the decision-making, this gave us all the disadvantages of the soviet system, with erring or corrupted central decision-makers, dramatic mistakes, and carelessness of decision-makers at any other level. This system also encouraged the worst kind of innovations, those that only helped to circumvent regulations. Like the soviet system also, it seems incapable of reforming itself. Making it a monopoly, as Warren Buffett seems to suggest (as mentioned in your article), would only make matters worse.

A radical solution is needed, such as prohibiting issuers to pay for a rating, making professional investors and banks accountable again for their screening in selecting their assets, and deleting any reference to ratings by regulators. Any shop offering advisory or rating services should then try to sell them to investors and convince them of their merits.

If that kills the false safety produced by the present rating system and makes the over-leveraging of weak borrowers and structures more difficult, so much the better.

Maybe Paul Volcker could have a word with Mikhail Gorbachev about this?

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