

Warning: Rating agencies may be harmful to your (financial) health

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Standard & Poor's has downgraded Greece, Portugal and Spain and has warned Ireland that it might suffer a similar fate. Do I hear this right?

Is S&P still in the business of producing risk analyses? Should the rating agencies not have gone out of business after they told us for years that the risk associated with the ballooning debt of banks and major companies was nothing to worry about? How can these agencies, which were systematically wrong in the past, have any credibility in whatever risk analysis they make?

Yet, remarkably, they are alive and well, and their credibility seems to have been restored. The market believes the rating agencies today when they warn us of risks associated with a number of eurozone governments' debt. As a result, the interest rate these governments have to pay on their borrowings increases.

In the recent past the market believed the same rating agencies when they put a stamp of approval on the exploding debt of private companies. As a result, these companies could finance themselves in the markets at ever lower interest rates. It led to disaster.

In statistics, a distinction is made between type I and type II errors. A type I error occurs when a hypothesis (e.g. a company is risky) is rejected when it should have been accepted. A type II error occurs when a hypothesis (the company is risky) is accepted when it should have been rejected.

The rating agencies have systematically made type I errors in the past. They had an excessive faith in the soundness of the private companies they were rating and failed to identify massive risk-taking by these companies, until the crisis erupted.

There is no reason to believe that agencies that have excelled at making type I errors could not equally excel at making type II errors. In fact, we have every reason to believe that they will do so. Having made systematic type I errors they are now more likely to make type II errors, finding risks where few exist. In the past they were excessively-optimistic; they now react by being overly-pessimistic.

Government debt in the eurozone has declined steadily since 2000 (from 69% of gross domestic product in 2000 to 66% in 2007). The government debt of Greece, Ireland and Spain has declined even faster than that of the eurozone as a whole. The latter two had a level of government debt that was about half that German and US levels in 2007.

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True, since the eruption of the crisis in 2008, government debt in these countries has been increasing fast. But US and UK government debt is rising equally fast. No warnings have been issued against the US and the UK.

Thus it appears that the rating agencies are not only overreacting and crying wolf (a type II error), they also are also being highly selective in their overreaction. Some countries' governments are singled out while others are not, for reasons that are obscure.

We are all subject to biased beliefs. The problem arises when such beliefs affect the analysis of rating agencies, which have considerable power in moving markets, rewarding some and punishing others. The rewards and punishments distributed by rating agencies have huge implications.

If ratings are given objectively, there is no problem; on the contrary, they provide the right incentives for all who are in the process of taking risks. But the rating agencies have been systematically wrong in handing out rewards and meting out punishments. In the past they gave incentives to take too much risk; today they give incentives to take too little, thereby exacerbating the crisis.

It is time to mete out punishment to rating agencies. Ideally, after so much incompetence, one would like to shut them down. But this is unlikely.

My proposal would be to borrow from the approach adopted towards the tobacco industry. Just as cigarette packets must carry information alerting consumers to the dangers of smoking, so we could oblige the agencies to issue health warnings with their ratings.

The wording could be as follows: "Scientific evidence has shown that this rating is likely to harm you. If it is favourable, it is likely to have overlooked your weaknesses, thereby making you complacent and harming you.

If it is unfavourable, it will harm you even if you do not deserve it".

As with cigarettes, such a warning might reduce our addiction to ratings, and we would all feel better.