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Using Basel II to Facilitate Access to Finance: The Disclosure of Internal Credit Ratings

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Abstract

The advancement of their risk management activities makes it profitable for major banks to rely on internal credit ratings to calculate Basel II capital requirements (IRB approach). Firms and, more generally, market participants would benefit from the disclosure of these ratings, as it would reduce their cost of capital and facilitate investment diversification. Banks, however, have no interest in making their data publicly available.

This paper proposes a regulatory framework to efficiently solve this incentive issue. It first shows that there are net benefits in requiring the disclosure of internal ratings. The paper then sketches regulatory requirements that would minimize disclosure costs and interest group opposition. Banks opting for the IRB approach would have to provide their internal ratings to one of several regional entities. The latter would consolidate the data collected and giver each borrower a rating equal to the average of the ratings it gets from its lenders. The average rating would be disclosed to the public unless the borrower has opted for non-disclosure. Relying upon multiple regional entities may cause some uncertainty (a given firm may get diverging average ratings), but it would also reduce moral hazard effects and foster competition in the rating industry.

Keywords: Access to finance, Basel II, banking, capital requirements, disclosure, internal ratings, IRB approach, lenders, rating agencies.

JEL Classifications: G21, G28, G32, K22

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I. Introduction

Under the revised capital adequacy framework (Basel II), banks will be allowed to calculate regulatory capital using either a standardized approach to credit risk or a more sophisticated internal rating based (IRB) approach.[1] The IRB approach should bring capital requirements closer to credit risk profiles and all major banks can be expected to adopt it.

Basel II has generated substantial discussion about the reduction in regulatory capital it is likely to generate. However, the transparency opportunities it offers have been largely ignored. This paper suggests that it would be efficient to require all banks opting for the IRB approach to disclose their internal rating information to the public.

The externalization of internal rating information should not result in significant inconsistencies. National financial systems continue to differ due to country-specific trade-offs (compare Milgrom and Roberts 1994; Lipsey and Lancaster 1956), but there is a convergence trend. Financial intermediaries play an increasingly similar role in both market-oriented and (still) intermediary-oriented systems. Operational firms, for their part, are increasingly subject to a common regulatory framework when it comes to external finance, as exemplified by the development of regulatory arbitrage within Europe, the convergence of venture capital contracts around the world and the harmonization of disclosure requirements and practices.

Against this background, requiring the disclosure of internal ratings would have the advantage of reducing the cost of capital for large and small firms alike. It would provide lenders and investors with a richer data set. Moreover, disclosure should improve rating reliability, facilitate investor diversification and decrease market uncertainty. To be sure, internal rating disclosure would also have its costs. It could increase market volatility and negatively affect inter-temporal risk allocation. It also may negatively affect lender-borrower relationships, which could result in adverse selection effects or make it more difficult for lenders to obtain rating information.

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[1] See *International Convergence of Capital Measurement and Capital Standards*, available at bis.org.

This paper argues that it is possible to design a regulatory framework under which the benefits of mandatory rating disclosure clearly outweigh its costs, which in turn should minimize interest group opposition to the externalization of banks' private information. First, it would remain possible for lenders to keep internal ratings confidential by opting to continue to use the standardized approach. Second, lenders that opt for the IRB approach would not have to disclose the internal ratings themselves, but would do so through one of several (public or private) regional entities.

Third, regional entities would publicize ratings in consolidated form. Each borrower would get a rating corresponding to the average of the individual ratings it gets from its lending banks. This procedure would have several advantages. It is likely to improve rating quality (extremes will at least partly cancel each other out) and protect individual lender anonymity. It would also allow individual lenders to keep a comparative advantage (or reduce a comparative disadvantage) if their internal rating differs from the disclosed average. Admittedly, overlapping disclosure by multiple regional entities may cause some uncertainty as a given firm may get diverging average ratings. However, rating multiplicity would also reduce moral hazard effects (excessive rating reliance would be prevented) and preserve competition by non-bank rating firms (they could continue to offer uncertainty reducing services).

Fourth, borrowers would be allowed to opt-out. The availability of a non-disclosure alternative should protect borrowers against rating mistake risks. It should also minimize reductions in the information flow between borrowers and lenders because of relationship damaging disclosure.

The remainder of the paper is structured as follows. Section II provides an overview of the internal rating approach under the Basel II agreement. Section III discusses the inconsistency risk as well as the specific costs and benefits of mandating the disclosure of internal ratings. Section IV sketches a simple regulatory framework under which this private information could be efficiently externalized with minimal interest group opposition.

II. Basel II and Internal Credit Ratings

On June 26, 2004, the central bank governors and the heads of bank supervisory authorities in G10 countries approved a revised capital adequacy framework, commonly referred to as Basel II.[2]

The revised framework, which is expected to be implemented by year-end 2007, aims at providing banks with more risk-sensitive capital requirements. Regulatory capital is to be calculated under either a standardized approach to credit risk or an approach based on banks' internal ratings (IRB). Banks that opt for the IRB approach can expect their capital requirements to become closer to their credit risk profiles. However, only banks that have robust validation procedures will be allowed to use the IRB approach – meaning that supervisory approval of IRB is likely to be restricted to sophisticated intermediaries.

Under the IRB approach, credit exposures must be categorized in five broad classes of assets, that is corporate, sovereign, bank, retail (which may include corporate exposures of less than €1 million), and equity. Banks will also be permitted to distinguish between exposures to small and medium-sized firms and exposures to large firms.

Banks opting for the IRB approach will have to use internal ratings for credit approval, risk management and internal capital allocation purposes. As far as corporate exposures are concerned, the rating system must include a minimum of seven borrower grades for non-defaulted borrowers and one for those that have defaulted – with credit risk increasing from one grade to the next. A borrower's grade must not only reflect its current financial condition.[3] The grade must also indicate the borrower's ability and willingness to contractually perform despite adverse economic conditions or the occurrence of unexpected events. In other words, there is a link between credit rating and probability of default (Krahnen and Weber 2001).

In the past decade, risk management has become an important activity for financial intermediaries (Allen and Santomero 1998), whereas credit risk capital allocation increasingly

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[2] The *International Convergence of Capital Measurement and Capital Standards* (Basel II, available at bis.org) are replacing a first set of standards set out by the 1988 Basel Capital Accord.

[3] Note that financial condition is influenced by financial as well as non-financial factors such as management quality and corporate governance. See e.g. Grunert, Norden, and Weber (2005).

plays a role for determining the bonuses of bank managers. Reflecting this evolution, there is widespread use of internal credit risk rating grades by major banks across developed countries (see e.g. Carey and Hrycay 2001 for the U.S.; Krahnen and Weber 2001 for Germany). Taking into account that IRB requirements have been developed on the basis of existing practices, most, if not all of these major banks can be expected to opt for the IRB approach.

The generalization of internal ratings does not imply that there is uniformity among banks in firm grading. Empirical studies show that there can be substantial differences among internal rating systems (see Treacy and Carey 2000 for the U.S) and in risk assessments (see Jacobson, Lindé and Roszbach 2004 for Sweden). These differences will not disappear under Basel II, the regulatory framework being flexible and leaving room for diversity in implementation by individual banks.

These differences, however, are unlikely to remain significant or prevent a comparative analysis of internal ratings. First, supervisory authorities will require banks using the IRB approach to establish that their ratings are consistent and meaningfully differentiate risk. This should minimize internal rating system divergence, as confirmed by the current trend towards using the Standard & Poor's 26 borrower grade scale for internal rating purposes (see also Altman and Saunders 2001). Second, differences in rating methods and grades among the major external rating agencies (Standard and Poor's, Moody's in particular) do not prevent market participants from using and comparing them.[4]

Given the lack of competition in the external rating industry and rampant skepticism about the quality of credit ratings produced by its major players, the forthcoming availability of "authorized" and, therefore, consistent internal ratings naturally leads to the question of whether it would be advantageous to disclose them to the public.

III. Efficient Disclosure of Internal Credit Ratings

Financial markets are generally divided in two categories, intermediary-oriented systems (basically continental European and Japanese systems) and market-oriented systems (basically Anglo-Saxon systems). The difference in regimes brings the risk that harmonization efforts

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[4] The difference between „internal" and „external" ratings is that the former are attributed by lenders for their own purposes whereas the latter are done for third party use by specialized providers (also called rating agencies).

will result in inconsistencies (see Schmidt and Tyrell 2004; Schmidt and Spindler 2003; Pistor, Raiser, and Gelfer 2000). On the other hand, we can observe a convergence towards market-oriented systems in all developed countries (Allen and Gale 2000). Differences are not only being reduced by capital markets gaining in importance across countries. Financial intermediaries also contribute to the convergence trend by playing increasingly similar roles in both market-oriented and (still) intermediary-oriented systems (see Breuer 1998).

Of course, differences among countries will not disappear in the near future. However, convergence significantly reduces the risk that internal ratings disclosure requirements will result in significant inconsistencies. This conclusion is reinforced when considering regulatory arbitrage developments within Europe, the global standardization of venture capital contracts and the harmonization of disclosure requirements and practices.

A. Inconsistency Risk

Regulatory arbitrage. Three recent decisions by the European Court of justice have made it significantly easier for new firms to incorporate in a Member State other than the one they conduct business in.[5] There is some debate about whether these decisions will result in many firms engaging into regulatory arbitrage and in regulatory competition developing among Member states. What cannot be disputed, however, is the increase in the number of firms choosing to be governed by UK law (a so-called outsider-controlled jurisdiction), even though they will operate in Germany (a so-called insider-controlled jurisdiction). It is also noticeable that France, Germany and the Netherlands have recently undertaken legislative reforms in the wake of UK regulatory changes (Hertig and McCahery 2003).

These developments are likely to produce a three-staged outcome. First, most EU Member States will face a situation where closely-held firms operating on their territory will be governed by corporate laws that are enacted by another Member State. Second, if early U.S. developments have any comparative value, the cohabitation of closely-held firms subject to different regimes is likely to produce converging corporate laws (Carney 1998). Third, some closely held firms will become public under the regulatory regime of a Member State

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[5] See Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 ECR I-1459; Case C-208/00 Überseering BV v. NCC Nordic Construction Company Baumangement 2002 ECR I 9919; Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd (2003, available at curia.eu.int/jurisp).

other than the one in which they operate, putting high pressure on the latter Member State to adjust its own regime for publicly-held firms. As a result, the European regulatory framework governing access to external finance is likely to converge further, which in turn will reduce inconsistency risks.

Venture capital contracts. Whereas the U.S. venture capital market is large and well established, European venture capital activity was still close to non-existent in the mid-1990s (see Black and Gilson 1998). In recent years, however, venture capitalists have become increasingly active in Europe, with investments averaging around €10 billion per year since 1999.[6] This favorably compares with current levels of U.S. venture capital financing. For example, funds raised for the European market in 2003 were up to about two-thirds of those raised for the U.S. market (€6'350, respectively U.S.$11,183 billion).[7] To be sure, U.S. venture capital activity has seen a dramatic decline since 2001, but this is also true for Europe and reflects the cyclical nature of the business (Lerner 2002).

Interestingly, the development of the European venture capital market has gone hand-in- hand with a gradual replication of U.S. practices. A keystone of the U.S. venture capital market is that information asymmetries, conflicts of interests and uncertainties are dealt with through private ordering (Gilson 2003). Very early European attempts to develop a venture capital market relied upon governmental financing, the usual European approach for risky projects, but were plagued by failures (see Becker and Hellmann 2004). When experienced U.S. venture capitalists started investing in Europe, they used the U.S.-style contracts with which they were familiar. The available empirical evidence shows that the approach proved successful across jurisdictions, regardless of the applicable legal regime (Kaplan, Martel, and Strömberg 2004).

This result may reflect smaller than expected divergence between the U.S. and German poles (see Bascha and Walz 2001), or rapid convergence due to German banks' realization that venture capitalism was likely to foster their lending activities (see Hellmann, Lindsey and Puri 2003). In any event, venture capital is a good example of the increasing

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[6] Source: ECVA 2004 Yearbook

[7] Source: ECVA 2004 Yearbook (for Europe) and Thomson Venture Economics & National Venture Capital Association (fort he U.S.).

similarity of financial systems and the potentially limited role of inconsistencies when it comes to external finance.

Harmonized disclosure. EU jurisdictions and Japan impose more stringent accounting and disclosure requirements on closely-held firms than the U.S., whereas the latter regulates more heavily disclosure by public companies. Moreover, public corporations are subject to higher regulatory pressures in the U.S. when it comes to forward-looking information.

However, market pressures have reduced the regulatory gap by forcing U.S. closely-held corporations as well as European and Japanese public corporations to disclose more data than required by applicable regulation (Hertig and Kanda 2004, Hertig, Kraakman and Rock 2004). In other words, despite of claims about differences in governance regimes requiring separate modes of information processing to avoid prohibitive inconsistencies, market forces have led to *de facto* harmonization of disclosure practices.

Law-makers are attempting to consolidate and extend the scope of convergence in disclosure. For example, the more than 7000 EU firms traded on regulated markets have been required to comply with Anglo-Saxon-oriented accounting standards.[8] Similar policies are being implemented in Japan.[9] Here again, the harmonization path is not always smooth, and differences will remain in disclosure requirements or practices. However, those differences reflect diverging views about the costs and benefits of disclosure in a market-oriented financial system and cannot be considered a source of financial system inconsistencies.

Summing up, the dynamics of regulatory arbitrage, globalization of venture capital financing and disclosure harmonization make it unlikely that mandating the disclosure of internal ratings will result in significant inconsistencies.

B. Costs and Benefits of Disclosure

The above conclusion does not, however, mean that the benefits of internal rating disclosure requirements exceed their costs. It is well known that credit markets are characterized by

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[8] See Regulation on the Application of International Accounting Standards [2002] OJ L 243/1.

[9] See Charles Smith, *Called to Account*, INSTITUTIONAL INVESTOR, December 2002 at 62; but see Barney Jopson and David Pilling, *Accounting Teams Struggle to Sing to a Similar Tune*, FINANCIAL TIMES, March 9, 2005 at 14 (convergence is a lengthy process).

incomplete information, which gives rise to problems of adverse selection and moral hazard (Allen and Gale 2000). Mandating internal ratings disclosure can thus be expected to reduce the cost of capital, but the strategy may also have disadvantages in terms of data reliability, risk sharing, market uncertainty and rating providers. These potential trade-offs justify a more detailed cost-benefit analysis.

Cost of Capital. Internal ratings disclosure is likely to provide investors with richer and timelier information than currently available from external rating firms. This should reduce the cost of capital for both publicly-held and closely-held firms.

For listed firms or initial public offerings, the disclosure of internal ratings should lead to an increase in stock prices as investors will expect lower returns following the disclosure of private information (Easley and O'Hara 2004). The same should be true for larger non-listed firms. Lenders' regulatory capital requirements will be lower under the IRB approach than under a standard approach, which should allow large non-listed firms to profit from improved loan pricing (see also Dietsch and Petey 2002).

Internal rating disclosure should make smaller non-listed firms more attractive for venture capitalists and private equity investors. It is indeed often difficult for smaller firms to get a reliable rating from external rating providers, either because smaller firms deem rating costs and risk not worth the reward or because there is insufficient supply of external rating capabilities. The externalization of lenders' internal ratings information would therefore reduce venture capitalists' and private equity funds cost of information gathering and processing. These financial intermediaries will thus be able to make better use of their information assessment capabilities, in turn facilitating smaller firms' access to finance.

Data Reliability. Borrowers generally have longstanding relationships with one or several banks, giving the latter privileged access to firm-specific information. Hence, major banks can be expected to often have better solvency information than rating agencies and other providers of financial information.

On the other hand, an analysis of insolvencies throughout the twentieth century would reveal many examples of uninformed lenders. It is also probable that current pressure to cut costs will result in some lenders lacking adequate monitoring capabilities. Remember,

however, that only sophisticated lenders will get supervisory approval to use the IRB approach. Internal ratings disclosure will thus be limited to banks with validated tools and procedures.

To be sure, regulatory approval will not eliminate the risk of internal credit ratings being based on deficient information or biased because of lenders' regulatory capital interest in tampering ratings upwards (Carey and Hrycay 2001). Switching from the standardized to the IRB approach could also result in excessive reliance on models, which may increase systemic errors (if many lenders use similar models) and lead to the disregard of critical subjective information (such as failure to pass the "smell test").

Nevertheless, these risks should not be over-estimated. First, the race for competitive advantages and differences in corporate cultures are likely to make internal ratings vary from lender to lender, a phenomenon that can already be observed across rating agencies. This should improve supervisory authorities' capability to timely detect anomalies and prevent blind reliance on faulty models. Second, model dependence issues should not prevent internal ratings from being more reliable than currently available rating data. As indicated, lenders are generally better informed than rating agencies. Moreover, lenders should face lower reputation and liability risks when significantly downgrading a borrower than firms that sell rating data. Indeed, the move would reflect prudential rather than informational considerations, reducing the likelihood of market or judicial sanctions.

One could argue, however, that the reliability advantage of internal ratings may end up being an issue by itself. First, it may result in excessive investor reliance. However, this potential moral hazard effect should not be over-estimated. Adding internal rating to external rating information can, as we shall see, be a source of stock price volatility and this should keep investor reliance within acceptable limits. In addition, it is possible to further reduce moral hazard effects by institutionalizing multiple rating sources (see Section IV).

Second, lender disclosure of low internal grades may have stigma effects, especially for listed firms with small sized capitalization or for very small firms. External rating firms may pay limited attention to small caps, which could magnify the impact of lower internal rating disclosure. Very small firms may have only one rating, the one provided by their single

lender, and downgrades could make it very difficult for them to get alternative sources of finance.

The fact that the stigma effect could increase the cost of capital for certain firms does not necessarily mean that it is a source of inefficiency. For small caps, the stigma effect is likely to merely reflect the improved and timelier nature of rating information. For very small firms, the stigma effect may remain a hypothetical one to the extent they are less likely to borrow from lenders who use the IRB approach.

Risk-Sharing. Disclosure could increase risk sharing opportunities. First, the availability of major banks' internal ratings may decrease the probability that unsophisticated lenders using the "crude" standardized approach will take uninformed lending risks (see Rime 2003).

Second, internal rating disclosure should facilitate investor portfolio diversification. The number of rated firms will increase and the granularity of existing credit ratings should improve, especially given the trend towards general use of a harmonized rating scale. Moreover, rating agencies' tendency to inflate the ratings of those firms that solicit their services (see Poon 2003) should decrease or, at least, be balanced by the availability of internal ratings.

Third, internal rating information should make investors less prone to become victims of conflicts of interests. This is especially true for investors that have their assets managed by financial intermediaries which also act as corporate lenders (compare Bolton, Freixas and Shapiro 2004). In such situations, the disclosure of internal ratings will make it more difficult for asset managers to "stuff" debt instruments that are unpalatable into the discretionary portfolios of unsuspecting investors.

On the other hand, internal rating disclosure may also reduce risk sharing opportunities. Banks have a comparative advantage in handling inter-temporal risk sharing, due to their ability to allocate risk and smooth consumption over time (see Allen and Gale 2000; Hirshleifer 1971). However, this advantage presupposes that households have at least part of their financial wealth in the form of deposit accounts rather than securities. If so, and should internal rating disclosure result in households transforming fixed claims against banks into securities, lenders' risk sharing ability may decrease.

Whether the net effect of internal ratings disclosure will be an increase or a decrease of risk sharing opportunities is ultimately an empirical question. It would, however, be rather surprising to see the potential costs in terms of inter-temporal risk sharing end up exceeding the sum of all the mentioned risk sharing benefits.

Market uncertainty and volatility. The availability of internal ratings in addition to existing external ratings should decrease market uncertainty. As mentioned, rate inflation due to the self-selection bias inherent to external ratings will be reduced. Moreover, market participants will be able to rely on a broader rating sample and get a better picture about the extent to which there is consensus on a given firm's solvency. Finally, internal rating disclosure should improve rating methodology transparency. Very limited information is currently available about the methodology used by rating agencies. By contrast, the methodology used by lenders under the ISB approach will be known to supervisory authorities. The latter can be expected to make the main rating parameters public, so as to streamline IRB approval procedures and facilitate regulatory monitoring. The disclosure will not only benefit users of internal ratings, but also put pressure on rating agencies to provide better information about their own methodology.

Internal ratings disclosure may also lead to a decrease in stock price volatility. In particular, lenders should prove faster than other providers of solvency data in adjusting ratings to changes in circumstances (see Claessens and Embrecht 2003). Investors would thus get information that is timelier, which should permit more accurate pricing and reduce stock price volatility. However, the benefits of timeliness should not be over-estimated, as it may also increase stock price volatility. This could, for example, be the case if there is significant variance in rating across banks or if there is a large increase in the frequency of rating reversals (see Löffler 2004).

Rating Providers. Somewhat counter-intuitively, rating agencies are also likely to benefit from the disclosure of lenders' internal ratings. It should reduce their liability risk when providing corporate ratings to banks using the standardized credit risk approach.[10] Credit rating agencies will be able to refer to internal ratings to either justify their call (if internal and

[10] Basel II provides that lenders using the standardized approach must have their credit risk measurement supported by external credit assessments.

external ratings are similar) or hedge their bets (if external and internal ratings diverge). Moreover, the availability of internal ratings as a new source of information should decrease the risk of rating agencies becoming regulated by supervisory authorities[11] or investigated by competition authorities. Indeed, the availability of internal ratings will make it harder to pin the blame for market failures upon rating agencies or to establish their market dominance.

By contrast, it could be costly for lenders to disclose their internal ratings (see also Kirstein 2002). First, they could expose themselves to significant liability. Borrowers could face higher than justified costs of capital or even be made insolvent because of being rated below what they should be. Investors or creditors could suffer significant losses because they have been misled by rating mistakes or delayed updates.

Second, lenders' relationships with borrowers could suffer from disagreements over internal ratings. This could not only negatively affect the gathering of borrower information, but also subject lenders to adverse selection effects. For any given lender, under-rated borrowers will look for other sources of finance whereas over-rated borrowers will stay put.

Third, free riders could take advantage of lenders that disclose their internal ratings. For example, some lenders may decide to gain a competitive advantage by relying on other lenders' internal ratings while refraining from disclosing their own**.** Or, to take another example, a disclosing lender's counter-party could use the rating information to asymmetrically improve its trading or bargaining position.

These disadvantages explain why lenders do not voluntarily disclose internal ratings, but do not imply that a disclosure requirement would be inefficient. As the next section will show, lender disclosure disadvantages can be minimized under an adequate regulatory framework.

Summing up, the costs of mandating the disclosure of internal ratings are unlikely to exceed its benefits. Admittedly, mandatory disclosure could increase the "flawed model" costs of the IRB approach and negatively affect inter-temporal risk sharing. However, the link

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[11] Compare International Organization of Securities Commissions (IOSCO), Code of Conduct Fundamentals for Credit Ratings Agencies (December 2004, available at iosco.org); Committee of European Securities Regulators (CESR), CESR's Technical Advice to the European Commission on Possible Measures concerning Credit Rating Agencies, Consultation Paper (November 2004, available at cesr-eu.org). See also Hill (2004).

between the adoption of a disclosure requirement and the occurrence of these disadvantages seems weak, as other factors are likely to play a much more significant role. The only real objection to mandatory disclosure has to do with its potential costs for lenders, an issue that can be dealt with by the proper design of the regulatory framework.

IV. Sketching a Mandatory Disclosure Regulatory Framework

It is relatively easy to design a procedure making the disclosure of internal ratings mandatory. Major legal issues could be avoided by integrating into Basle II a provision according to which the use of the IRB approach is contingent upon the public disclosure of internal ratings. The effort and time needed to achieve international harmonization would thus be significantly reduced. Constraints on lenders could also be kept low. On the one hand, banks could still avoid disclosure by opting for the standardized approach. On the other hand, compliance costs would be minimal for those banks opting for the IRB approach, as their choice makes the disclosure of ratings almost costless to them (see also Zingales 2004).

However, market participants as well as banking supervisors can be expected to oppose this "simple" procedure. First, lenders will argue that mandatory disclosure would leave them open to liability suits by borrowers, investors or creditors claiming to have been damaged by erroneous or misleading ratings. Lenders will also stress that internal rating disclosure will damage their relationship with borrowers and allow other market participants to take advantage of the revealed exposures. Second, small-caps and very small borrowers are likely to object to the requirement because of its perceived stigma effects. Third, rating agencies will oppose any development that could damage their own relationship with rated firms, in particular a requirement that would force them to disclose proprietary information.[12] Fourth, supervisory authorities may object because of the potential moral hazard effect of disclosing data generated by systems they have vetted. Lenders, investors and creditors may consider the disclosed ratings as backed by supervisors and thus reduce information gathering and processing efforts –the perception being that "guilty" supervisors will arrange for a bail-out in case of major borrower insolvency.

[12] See e.g. Charles Batchelor, *Rating Agencies Win Rule Victory*, FINANCIAL TIMES, December 28, 2004 (reporting IOSCO's abandon of a proposal to require rating agencies to make public confidential information obtained from companies seeking a rating).

This combination of interest group opposition is most likely to prevent the adoption of a straightforward conditionality approach. The efficiency and political economy issues raised by the disclosure of internal ratings must be dealt with under a more sophisticated regulatory framework. This paper thus proposes the adoption of a three step approach. First, internal ratings would be disclosed by a third party and as averages. Second, there would be multiple third party disclosure. Third, borrowers would be given the right to opt-out.

Third party disclosure. Requiring disclosure through a third party rather than directly by lenders has two advantages. It puts some liability distance between lenders and disclosure. It mimics the procedure for external ratings and should thus foster competition in the rating industry. Admittedly, the designation of the disclosing third party could be an issue, because its privileged access to rating information could lead to abuses. It may be necessary, at least in a first stage, to put a public entity in charge of disclosure – central banks being among the possible candidates, as exemplified by the Banque de France firm scoring practice (see Foulcher, Gourieroux, and Tiomo 2004).

In addition, third party disclosure would permit to institutionalize the publication of average ratings. As most borrowers deal with more than one major bank, the third party would be able to consolidate the various ratings a firm gets and disclose an "average" to market participants. Individual lender's contributions would thus remain anonymous, which would further distance lenders from the process and avoid direct effects on bank-borrower relatonships. Moreover, the disclosure of average ratings would allow better informed lenders to keep a competitive advantage while giving less informed lenders an opportunity to revise their analysis – or even reconsider the robustness of their IRB approach. The disclosure of averages could also reduce excessive subjectivity risks, as well as rating biases because of the regulatory capital advantages in tampering ratings upwards or the negotiation value of imposing a below market grade upon a recalcitrant borrower.[13]

From a methodology perspective, disclosing averages could be considered problematic. Major banks are unlikely to use uniform rating procedures and differences in the nature and importance of their relationship with individual borrowers may affect the relevance

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[13] See e.g. Alec Klein, *Credit Raters' Tactics in Pursuing New Work Frustrate Companies*, WALL STREET JOURNAL EUROPE, November 25, 2004 at A1 (reporting that borrowers refusing to ask for an external rating for costs reason where sanctioned by the unsolicited disclosure of low-grade ratings).

of their ratings (Elsas 2005). However, supervisory approval of IRB systems should prevent differences from being significant enough to make ratings inconsistent. In addition, the existence of differences in methodology should contribute to smoothing the effect of rating biases.

To be sure, the disclosure of averages may nevertheless mislead market participants insofar as they underestimate the extent to which major banks diverge in their estimation of the credit risks associated with an individual borrower. To deal with this issue, the disclosing third party could be required to single out borrowers with significant rating divergence or even to disclose standard deviation data.

Multiple rating disclosure. Given that large borrowers have relationships with major banks around the world, disclosure could be organized so as to take place through multiple third parties. For example, U.S. banks would report their internal ratings to a U.S. based third party, whereas European and Japanese banks would report theirs to a Europe-based, respectively Japan-based third party.

Having multiple ratings for one borrower may cause some uncertainty, but this would contribute to a reduction in liability risks and moral hazard effects. Uncertainty would make it more difficult for investors and creditors to attribute insolvency-related losses to a single third party, bank or supervisor. It would also prevent excessive internal rating reliance by market participants and leave those best placed to monitor borrowers with an incentive to do so. In addition, having multiple rating disclosures would avoid giving excessive power to any third party and, probably, foster competition in the rating industry.

Opting-out. Finally, each borrower could be given the right to avoid disclosure by instructing its banks not to provide its internal rating to the disclosing third parties. Allowing borrowers to opt-out would significantly reduce the potential for stigma effects as well as the risk that disagreements over ratings end up damaging lending relationships. At the same time, the availability of such an option is unlikely to result in a significant number of borrowers opting out. Firms that opt-out would have to explain to their investors or creditors why they do not want their internal ratings to be disclosed. This should limit the exercise of opt-outs to those instances where borrowers have solid reasons to oppose disclosure.

Minimizing opposition. The proposed framework should minimize opposition to mandating the disclosure of internal ratings. Investors can be expected to welcome a requirement that improves transparency, facilitates portfolio diversification and reduces the risks related to conflicts of interests. Similarly, the majority of borrowers should be in favor of a mechanism that is likely to reduce the cost of external finance while leaving a possibility to opt-out.

Rating agencies and major banks could prove less enthusiastic. However, rating agencies should be quick to realize that uncertainties inherent to the proposed framework leaves them sufficient room for the provision of value-added services while reducing the risk of regulatory intervention because of rating deficiencies or insufficient competition. Major banks, for their part, could have an interest in being given an opportunity to calibrate their internal ratings against average ratings. Both rating agencies and banks may still find the *status quo* as interesting or even preferable, but it is unclear why they would engage in a major lobbying effort to oppose a reform that does not cost them much.

Finally, supervisory authorities should prove supportive of a disclosure requirement that improves transparency, allows for multiple cross-checks of internal ratings and leaves room for enough uncertainty to avoid moral hazard effects. More importantly, supervisory authorities should be willing to implement a mechanism that is likely to improve financial stability by providing more timely warnings of industry specific, country specific or a more general deterioration of the economy – especially considering that they drafted Basel II with the aim of minimizing systemic risk and its impact on financial stability.

V. Conclusion

This paper argues that the Basel II accord provides an opportunity to efficiently externalize internal rating information across jurisdictions, regardless of the orientation of their financial system.

It is thus proposed to require the disclosure of internal ratings of those banks that adopt the IRB approach for calculating capital requirements. Disclosure would occur in averaged form through multiple third parties, whereas borrowers would be allowed to opt-out to prevent outsiders from having access to their internal ratings.

This framework would minimize the disadvantages of disclosure while preserving its advantages. As a consequence, one could expect interest group opposition not to prove strong enough to prevent its implementation.

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