ADBI Working Paper Series

The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective

Siegfried Utzig

No. 188
January 2010

Asian Development Bank Institute

Siegfried Utzig is director of the Association of German Banks in Berlin. An earlier version of this paper was presented at the Conference on Credit Ratings, Credit Rating Agencies, and their Development in Asia, held 1–2 July 2009 at ADBI in Tokyo.

The views expressed in this paper are the views of the authors and do not necessarily reflect the views or policies of ADBI, the Asian Development Bank (ADB), its Board of Directors, or the governments they represent. ADBI does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequences of their use. Terminology used may not necessarily be consistent with ADB official terms.

The Working Paper series is a continuation of the formerly named Discussion Paper series; the numbering of the papers continued without interruption or change. ADBI's working papers reflect initial ideas on a topic and are posted online for discussion. ADBI encourages readers to post their comments on the main page for each working paper (given in the citation below). Some working papers may develop into other forms of publication.

Suggested citation:

Utzig, S. 2010. The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective. ADBI Working Paper 188. Tokyo: Asian Development Bank Institute. Available: http://www.adbi.org/working-paper/2010/01/26/3446.credit.rating.agencies.european.banking/

Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

© 2010 Asian Development Bank Institute

Abstract

Credit rating agencies (CRAs) bear some responsibility for the financial crisis that started in 2007 and remains ongoing. This is acknowledged by policymakers, market participants, and by the agencies themselves. It soon became clear that, given the depth of the crisis, CRAs would not be able to satisfy policymakers by eliminating flaws in their rating methods and improving corporate governance. Although the CRAs were more or less unregulated before the outbreak of the financial crisis, after the crisis started, politicians became increasingly vocal in demanding regulation. Initially, these demands were confined to a more binding form of self-regulation. But as the crisis progressed, the calls for state regulation grew ever louder. It became apparent after the November 2008 G-20 summit in Washington that state regulation could no longer be avoided.

In Europe, the course had been set in this direction even before then. Since European policymakers saw the crisis as evidence that the Anglo-Saxon approach to the financial markets had failed, they believed they were now strongly placed to have a decisive influence on shaping a new international financial order. It is remarkable to note the shift in European policy from a self-regulatory approach, which was comparatively liberal in international terms, to quite rigorous state regulation of CRAs. Both the European Commission and the European Parliament drew up far-reaching plans. Although European policymakers knew that only globally consistent regulation would be appropriate for a new world financial order, their initial draft legislation was geared more toward stand-alone European regulation.

While the final version of the European Union Regulation on Credit Rating Agencies focuses firmly on the European arena, the key point for all market participants is that this is unlikely to have an adverse effect on the global ratings market. It must nevertheless be recognized that the scope of the selected regulatory approach is extremely narrow. Certainly, it has the potential to improve the corporate governance of CRAs and prevent conflicts of interests. But it can do nothing to address the repeated calls for greater competition or for CRAs to be made liable for their ratings.

JEL Classification: G01, G18, G21, G24

Contents

1. Introduction 1

2. The Role Played by Credit Rating Agencies in the Financial Crisis 1

3. Regulation of Credit Rating Agencies: Why and How? 4

4. Regulation from the Perspective of Market Participants 6

5. The Regulation of Credit Rating Agencies before the Financial Crisis 7

    5.1 The Importance of the IOSCO Code 7
    5.2 The Regulation of Credit Rating Agencies in the US 7
    5.3 The Regulation of Credit Rating Agencies in the EU 8

6. Political Demands and Conclusions in Light of the Financial Crisis 9

7. Regulatory Measures Introduced During the Financial Crisis 12

    7.1 Revision of the IOSCO Code 12
    7.2 Revision of the Credit Rating Agency Reform Act 13
    7.3 Measures in the EU 14

8. The EU Regulation on Credit Rating Agencies 15

9. What Remains to be Done? 18

References 20

1. INTRODUCTION

There is a broad consensus that credit rating agencies (CRAs) contributed to the current financial crisis, which began in the United States (US) in summer 2007 with problems in the subprime mortgage market and has since taken on global dimensions. The agencies underestimated the credit risk associated with structured credit products and failed to adjust their ratings quickly enough to deteriorating market conditions. CRAs were accused of both methodological errors and unresolved conflicts of interests, with the result that market participants' confidence in the reliability of ratings was seriously shaken. It is unsurprising, against this backdrop, that a heated debate emerged about the rating process, rating agencies, competition, and liability rules, prompting calls by politicians for greater regulation of CRAs.

Yet such calls are not solely a product of the present financial turmoil. They have featured on the agenda of international financial market policy since, if not before, CRAs came under fire in the wake of the series of debt crises starting in 1997. Nevertheless, there was no rush to take legislative action. On the contrary, the Code of Conduct Fundamentals for Credit Rating Agencies, published by the International Organization of Securities Commissions (IOSCO) in 2004, sent a clear signal that policymakers preferred a self-regulatory approach. And this approach appeared to be successful inasmuch as all the big CRAs subscribed to the Code. In the European Union (EU), the approach was supported by a consensus between the Committee of European Securities Regulators (CESR) and the European Commission that regulation should be put on hold for the time being. This strategy was especially remarkable given that 2006 saw the Credit Rating Agency Reform Act subject CRAs in the US to state regulation for the first time.

The phase of self-regulation has now come to an end with the adoption in the EU of the Regulation on Credit Rating Agencies. Since the financial crisis began, policymakers in Europe at both national and European levels have been consistently self-confident in calling for Europe to lead the way in international financial market regulation. This paper will examine whether and, if so, to what extent this ambition conflicts with the need for any steps to improve financial stability—be they in the form of legislation or self-regulation—to be based on coordinated international action.

2. THE ROLE PLAYED BY CREDIT RATING AGENCIES IN THE FINANCIAL CRISIS

The growth of the international financial markets over the last twenty years would have been unthinkable without CRAs. Only because of the availability of clear, internationally accepted indicators of the risk of default were investors willing to invest in international securities—whether corporate or government bonds—whose credit quality they would have been virtually unable to assess on their own. The CRAs worked for decades on designing a simple and readily understandable system that would allow any investor to invest in international securities with which they were not directly familiar. Where corporate and government bonds are concerned, this system has proved reliable and enabled investors to diversify their portfolios.

In the markets for structured products, by contrast, the role of the CRAs goes far beyond eliminating information asymmetry. Markets for structured products could not have developed without the quality assurance provided by CRAs to unsophisticated investors about inherently complex financial products. CRAs have operated as trusted gatekeepers. However, the ratings for structured credit turned out to be much less robust predictors of future developments than were the ratings for traditional single name securities.

Over the past two years, changes in the ratings of structured credit have been far more volatile than the historical record for single name credits, and far more weighted toward downgrades. The resulting instability of ratings has not only had direct procyclical effects, but has undermined confidence in the future stability of credit ratings. Against this backdrop, calls for CRAs to be regulated in a new and more stable world financial order fell on fertile ground, all the more so given that the CRAs could be accused of making some serious errors. A number of official European reports have now described in detail how certain flaws in the rating process and the conditions governing the financial markets contributed to the crisis.

The first comprehensive analysis appeared on 7 April 2008, when the Financial Stability Forum (FSF) published its report on enhancing market and institutional resilience (Financial Stability Forum 2008). This report concluded that the CRAs' substantial underestimation of the risk inherent in structured finance products was partly due to methodological shortcomings. Singled out for criticism were the inadequate historical data, which significantly increased model risk, and the fact that CRAs had not taken sufficient account of deteriorating lending standards.

The report took a positive view of the measures already introduced by the CRAs; nevertheless, a need was seen for further steps to improve internal governance, the transparency of rating procedures, and compliance with international codes of conduct. There was criticism, too, of CRAs' failure to publish verifiable data about their rating performance. The agencies were urged to disclose this information in as standardized a form as possible.

The report also called for a distinction to be made between ratings of structured finance products and other corporate bonds in order to highlight the differences in the methodologies used and the significantly different risk characteristics involved. The FSF felt, however, that more in-depth analysis was needed of the implications of such a step for the functioning of the market and the regulation of the industry.

In addition, the FSF report criticized CRAs for failing to adequately monitor the quality of securitized products. More rigorous scrutiny of lending practices was therefore called for. And last but not least, investors and supervisors were called on to examine whether they may have placed too much confidence in ratings.

Further reports by expert bodies and regulators were published over the course of the following twelve months. In October 2008, the President of the European Commission, José Manuel Barroso, mandated Jacques de Larosière to chair a committee to give advice on the future of European financial regulation and supervision. In February 2009, the committee published a report that cited the following shortcomings (de Larosière Group 2009)[1]:

- CRAs lowered the perception of credit risk by giving AAA ratings to the senior tranches of structured finance products like collateralized debt obligations (CDOs), the same rating they gave to government and corporate bonds yielding systematically lower returns.
- Flaws in rating methodologies were the major reason for underestimating the credit default risks of instruments collateralized by subprime mortgages. The report was especially critical of the following factors, which were all felt to have contributed to the poor rating performances of structured products:
    - the lack of sufficient historical data relating to the US subprime market,
    - the underestimation of correlations in the defaults that would occur during a downturn, and

[1] The same points are made in the Turner Review issued by the Financial Services Authority (2009: 76).

  - o an inability to take into account the severe weakening of underwriting standards by certain originators.

- October 2008 also saw the German government appoint Otmar Issing, former Chief Economist at the European Central Bank, to chair a committee to draw up recommendations first for the Group of Twenty (G-20) summit in Washington and then for the follow-up summit in London. The committee's report drew attention to the part played by various unresolved conflicts of interests (Issing Committee 2008). It leveled the following criticisms at CRAs:
- The governance of credit rating agencies did not adequately address issues relating to conflicts of interests and analytical independence. Agencies competing for the business of rating innovative new structures may not have ensured that commercial objectives did not influence judgments on whether the instruments were capable of being rated effectively.
- Rating shopping by issuers contributed to a gradual erosion of rating standards among structured finance products. This negative effect resulted from the right of issuers to suppress ratings that they considered unwelcome, thereby exerting pressure on the agencies.

In March 2009, the United Kingdom (UK) Financial Services Authority published the Turner Review, which also highlighted the responsibility of CRAs in its analysis of the causes of the financial crisis. The review came to the following conclusions (Financial Services Authority 2009):

- The practice of making the models by which agencies rated structured credits transparent to the issuing investment banks created the danger that issuers were "structuring to rating," i.e., designing specific features of the structure so that it would just clear a certain rating hurdle.[2]
- The shift to an increasingly securitized form of credit intermediation and the increased complexity of securitized credit relied upon market practices that, while rational from the point of view of individual participants, increased procyclicality in the system.
  - o More securitization meant that a greater proportion of credit assets were held by investors seeking reassurance from credit ratings, and thus increased the potential aggregate effects of forced selling by institutions using predefined investment rules based on ratings.
  - o The use of market value or rating-based triggers increased in an attempt to improve investor and creditor protection.[3]

[2] The Issing Committee report makes a similar point, noting that ratings assigned to structured products are based on estimating the loss distribution of the underlying loan portfolio. These estimations rely on models that are not fully transparent to the industry. However, rating agencies provided "customer end" tools to their clients, which allowed banks to run pre-tests of their new securitization portfolios before submission to the agency. As a result, loan portfolios could be designed in a way that just met the criteria included in the relevant model, but may have additional risk pertaining to criteria not included in the model. As an example, consider information on whether first loss tranches are retained or not. Although we know that the sale of the so-called first loss piece lowers expected portfolio returns, this is not an explicit part of the rating model currently in use, and is therefore not reflected in the assigned rating. Hence, the issuer can raise its profits by selling first loss pieces, without disclosure to the investors. This gaming argument refers to structured finance products only, not to corporate bonds in general. The reason is that in structured finance, the tailoring of portfolio composition is feasible (easy, low cost), while it is infeasible (difficult, expensive) if the underlying asset pool is an entire corporation with its fixed assets (Issing Committee 2008).

[3] Senior notes of structured investment vehicles (SIVs), for instance, were often awarded high credit ratings on the basis that, if the asset value fell below defined triggers, the SIV would be wound up before senior note holders were at risk. At the system level, however, this resulted in attempted simultaneous asset sales by

- Arrangements that related the level of collateral posted in derivative contracts to the credit ratings of counterparties also had a significant procyclical effect.[4]

In summary, the following elements may be said to have had an adverse influence on the quality of CRAs' work:

- Overreliance on mathematical and statistical methodologies based on inadequate data,
- Insufficient consideration of market and macroeconomic developments as factors influencing ratings,
- Failure to take account of interdependencies,
- Disregard of conflicts of interests, and
- Inadequate disclosure practices with regard to models and model assumptions.

This outline of the ratings dilemma would be inaccurate if it were to focus only on shortcomings on the part of CRAs. It is also true that investors often accepted ratings uncritically and overestimated their significance. Not enough attention was paid to the fact that ratings are only estimates of the relative probability of default or expected loss on a debt instrument. They are not a detailed assessment of risk and say nothing about an instrument's price quality or liquidity. Ratings are no substitute for investment risk management, particularly as the information provided by CRAs is limited.[5]

3. REGULATION OF CREDIT RATING AGENCIES: WHY AND HOW?

"Credit rating agencies are the biggest uncontrolled power in the global financial system, and thus in the national financial system too," said the President of the Federal Financial Supervisory Authority (BaFin) as early as 2003 at a hearing before the German parliament's finance committee (Deutscher Bundestag 2003). In the US too, a growing number of voices argued for CRAs to be regulated in the wake of the Enron and WorldCom affairs. The calls for regulation that emerged during the present financial crisis and the measures now introduced did not therefore come out of the blue. Nevertheless, it is often unclear what the regulation of CRAs is intended to achieve.

One of the reasons for this is almost certainly that ratings fulfill several roles in the international financial markets. The question of whether and, if so, how CRAs should be regulated is therefore determined not least by the numerous potential areas of conflict with the state. If CRAs are regarded as normal companies, the focus will be on the lack of competition and efficiency arguments. If ratings-based regulation is taken as the starting point for consideration of the issue, the state will be interested in a smoothly functioning, reputable system delivering ratings of high quality. Conflicts of interests that adversely affect quality are also a concern. In addition, ratings make it easier to establish and enforce legal rights (see Gonzalez et al. 2004). And if the financial system as a whole is considered, structural problems such as exacerbating procyclicality will play a role. The various

---

multiple SIVs, and the rapid disappearance of liquidity (both for asset sales and for new funding) as market value limits were triggered and ratings were cut (Financial Services Authority 2009).

[4] Credit default swaps and other over the counter derivative contracts entered into by AIG, for instance, required it to post more collateral if its own credit rating fell. When this occurred in September 2008, a downward spiral of increased liquidity stress and falling perceived creditworthiness rapidly ensued (Financial Services Authority 2009).

[5] See also the de Larosière Group report (2009: 16). "But the use of ratings should never eliminate the need for those making investment decisions to apply their judgement. A particular failing has been the acceptance by investors of ratings of structured products without understanding the basis on which those products were provided."

arguments for regulating CRAs have been described extensively in academic literature and need not be pursued further here (see, for example, Dittrich 2007; Emmenegger 2006; Hill 2004).

The financial crisis has revealed elements justifying regulation in all of the above functions performed by ratings. Where structured products were concerned, information asymmetry was reduced far less than investors had anticipated. The gatekeeper role led to conflicts of interests and the use of ratings both to enforce legal rights and for prudential purposes increased procyclicality.

Any approach to regulating CRAs must therefore address the question of what should be regulated and with which tools—in other words how. Regulation will only succeed if it takes account of what ratings can and cannot achieve. A rating of a financial instrument provides information about the credit quality, i.e., the probability of default, of a specific company or financial product. It says nothing about "systemic risk"—that is to say the danger of a chain reaction resulting in a number of financial institutions getting into difficulties.

It may thus be concluded that, while it may be perfectly rational for individual firms and institutional investors to be guided by a rating when making their investment decisions, these decisions can destabilize the financial markets at a systemic level if downgrades and rating triggers result in mass selling, write-downs, and additional capital requirements. The key point determining whether systemic risk arises is consequently the extent to which individual defaults occur at the same time. Ratings provide no information about this. Hence, it would be a mistake to believe that regulating CRAs could have mitigated procyclicality. Regulating credit rating agencies can do nothing to solve the problems caused by using ratings for regulatory purposes. Lawmakers should therefore refrain from overreacting. Instead, they should consider enhancements to current regulation that will work in a prosperous economy as well as in challenging times.

Conversely, the objective of regulating CRAs can only be to make ratings more reliable and mitigate conflicts of interests. On the question as to how to achieve this objective, there is broad consensus that rating methodologies should not be monitored. This is not only for competitive reasons, but above all because regulation of this kind could result in the state being considered partly responsible for published ratings. This would be incompatible with the concept of private-sector credit rating agencies. Given that states themselves are also issuers of debt, moreover, a new conflict of interests would arise if the state were in a position to influence the methodologies used for assigning sovereign ratings.

The range of possible methods of regulation nevertheless remains extremely broad. At one end of the spectrum is the idea that CRAs should regulate themselves. At the other end, there are demands for the rating process to be entrusted to the public sector. Support for the latter solution is not only to be found on the political left;[6] it is evidently also favored by some academics. For instance, in an article published on 14 May 2009 on *Spiegel-Online*, the Internet edition of a German news magazine, the German economics professor and member of the German Council of Economic Experts Peter Bofinger called for the introduction of state credit rating agencies to prevent misjudgments of the kind made before the present financial crisis (*Spiegel-Online* 2009).

Between self-regulation and state credit rating agencies lies the model of state-regulated private-sector CRAs. While the introduction of state agencies may be excluded simply for the reason that the state would then also have to assume liability for ratings, the other two alternatives remain the subject of heated discussion. For a long time, policymakers accepted the arguments against state regulation. In Europe, it was only the present financial crisis that led to reconsideration.

[6] In a motion before the federal parliament of 15 November 2007, for example, the German Left Party (Die Linke) called for the creation of impartial, public-sector credit rating agencies (Deutscher Bundestag 2007).

From a market economy perspective, there is much to be said for self-regulation, i.e., allowing CRAs to set their own code of conduct. However, the success of any self-regulatory regime stands or falls with the question of control. First, there needs to be effective supervision to reveal deviations from the self-imposed rules. Second, there must be a mechanism to sanction deviations. Self-regulation in the credit rating industry is only an option if it fulfils both requisites. The obvious supervision tool is rating quality (see Dittrich 2007: 147). This is an instrument that can be easily monitored by market participants and the media. And investors, for their part, will only accept reliable ratings over the long term. The second requisite is also met by the quality criterion. CRAs are highly sensitive to poor informational quality and proven anticompetitive behavior because both lower issuers' willingness to buy ratings. A loss of reputation will endanger the business of any CRA, so it is a highly effective form of sanction. The supporters of this hypothesis—and these include the vast majority of market participants—have considered self-regulation on the basis of the IOSCO Code sufficient up to now.

For the advocates of state regulation, a key lesson to be learned from the current turmoil is that it is vital for ratings to be able to provide a reliable indication of a debtor's creditworthiness even in times of crisis. In their view, the present crisis proves that the self-disciplining role played by reputation cannot always be relied on and only functions over the long term. Self-regulation does not work effectively when the pressure of reputation as a controlling power exists only to a limited degree due to a lack of competition (see Blaurock 2007). In addition, the argument goes, a rating does not only buy an issuer information. It should not be forgotten that ratings also regulate market access. Against this backdrop, CRAs have not managed to demonstrate that they are able under the existing regime to successfully resolve conflicts of interests. State regulation advocates feel that, in the interest of financial market stability, the current market failure justifies state regulation.

4. REGULATION FROM THE PERSPECTIVE OF MARKET PARTICIPANTS

From the outset, market participants have had reservations about state regulation of CRAs. They believe it is first and foremost the responsibility of the rating agencies themselves to remedy the shortcomings that came to light in the financial crisis and repair their damaged reputation. This calls, in particular, for modifications to rating procedures, improved transparency, and a review of internal processes in the interest of high quality.

This is seen as the key prerequisite for ensuring that the securitizations market will function smoothly over the long term. In the view of market participants, the financial crisis does not change the fact that securitization has contributed significantly to the efficiency of the financial markets. Securitization allows risk to be spread more broadly and enables many categories of investor to diversify their investments more widely. It also facilitates improved risk management among issuers. This presupposes that risks have been accurately assessed.

The CRAs were aware of this problem and responded swiftly. They revised their models and the rating of originators, insurers, servicers, and law firms. They also expanded their disclosure practices, launched various consultations with market participants on methodological issues, subjected their internal structures and processes to a thorough analysis, and made certain adjustments. As a result, the risk of a repeat of the developments in the credit rating industry that led to the subprime crisis has doubtless fallen.

Market participants have nevertheless recognized that the rating process unquestionably contains incentive structures that can—at least in theory—encourage misconduct by agencies. Owing to the lack of competition in the ratings market, the pressure that clients can potentially exert is not, on its own, enough to force rating agencies to behave properly.

Even so, regulative action should be taken with care. It should always be capable of achieving the twin objectives of ensuring financial market stability and promoting the efficiency of the financial markets. No one will be helped by tight regulation that stifles innovation and growth in the financial sector. Regulation is not an end in itself.

It should also be borne in mind that national responses to these challenges will not suffice. Even the EU would be a suboptimal stage for action because ratings are usually addressed to investors worldwide. For these reasons, the supervision of CRAs should be globally consistent; on no account should ratings be influenced by having to meet differing regulatory requirements. This would destroy the international comparability of ratings, which is one of their key contributions to financial market efficiency, and there would be competitive distortions between issuers and financial centers.

In the absence of an international regulator, a consistent approach to regulating CRAs can be achieved only by coordinating the rules at international level. The IOSCO Code of Conduct represents such an internationally coordinated set of rules. This should therefore be the basis of any state regulation.

5. THE REGULATION OF CREDIT RATING AGENCIES BEFORE THE FINANCIAL CRISIS

5.1 The Importance of the IOSCO Code

In 2004, the Code of Conduct Fundamentals for Credit Rating Agencies were published by IOSCO (2004) in response to the CRAs' failings in the Enron and WorldCom affairs. They set out rules on ensuring the quality and integrity of the rating process, including the monitoring of ratings; on guaranteeing appropriate internal procedures and analyst independence in order to avoid conflicts of interests; on making sure that rating methods are transparent and that ratings can be adjusted if necessary without delay; on handling confidential information; and on disclosing the extent to which CRAs follow the Code. These rules were of a general nature; they did not prescribe methodological details such as ratios, models, or rating categories. For good reason, this was left to the agencies themselves.

The expectation was that the CRAs would incorporate the IOSCO Code into their own codes of conduct or explain in clear terms why certain aspects had not been adopted ("comply or explain"). Though the competent authorities monitored compliance with the Code, there was no sanctions mechanism. The Code provided the credit rating industry with an internationally accepted framework of self-regulation. Most CRAs—including the three market leaders—implemented the Code, often verbatim.

5.2 The Regulation of Credit Rating Agencies in the US

In the US, CRAs are officially registered as nationally recognized statistical rating organizations (NRSROs) if they satisfy the requirements set by the Securities and Exchange Commission (SEC); they are subject to extensive vetting. The SEC requirements incorporate many elements of the IOSCO Code.

The NRSRO system was introduced in 1975 and fundamentally revised in 2006. The approval process became a registration process. While this made it easier to obtain recognition as an NRSRO, the criteria to be met by agencies under the Credit Rating Agency Reform Act were significantly tightened (US Congress 2006). Since 2008, CRAs have been subject to SEC oversight in the form of disclosure requirements, among other things, and liability has been increased. CRAs are now held accountable for compliance with their own standards, which they file with the SEC (see Partnoy 2009; Dittrich 2007). Areas covered by the rules include the misuse of confidential information, the management of conflicts of

interests, a ban on certain practices, the appointment of a compliance officer and the disclosure of the agencies' financial development. The SEC has extensive powers to enforce these rules. Regulation in the US thus goes somewhat further than the IOSCO Code. Some of the Code's provisions are enshrined in law or in regulations issued by US supervisors and consequently have a more stringent effect than is the case in the EU, for example.

Interference by the SEC in the methodologies used by CRAs is strictly prohibited, however: "Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."[7]

The Credit Rating Agency Reform Act may definitely be deemed a success. Since its introduction, there has been a significant increase in the number of registered CRAs. While previously only the big three rating agencies were registered as NRSROs, 2008 saw ten agencies apply for and obtain NRSRO status from the SEC (2008a).[8]

5.3 The Regulation of Credit Rating Agencies in the EU

Before the outbreak of the financial crisis, the regulatory setup in Europe was based mainly on self-regulation within certain supervisory "crash barriers" in the form of the IOSCO Code. In 2005, the CESR recommended the European Commission not to regulate the credit rating industry at EU level for the time being. Instead, it proposed adopting a pragmatic approach and reviewing how CRAs implemented the standards set out in the IOSCO Code of Conduct (CESR 2005). CESR therefore drew up a strategy on the basis of voluntary compliance by CRAs and in December 2005 issued a press release outlining a process to review implementation of the IOSCO Code. This framework, agreed with the main CRAs operating in the EU, included the following three elements:

- an annual letter from each CRA to be sent to CESR, and made public, outlining how it had complied with the IOSCO Code and indicating any deviations from the Code;
- an annual meeting between CESR and the CRAs to discuss any issues related to implementation of the IOSCO Code; and
- an undertaking for CRAs to provide an explanation to their national CESR member if any substantial incident occurred with a particular issuer in their market.

Four rating agencies agreed to this voluntary framework (Moody's, Standard & Poor's, Fitch Ratings, and Dominion Bond). In January 2006 the European Commission concluded that no new legislative proposals were needed as things stood. The European Commission considered that the existing financial services directives, combined with self-regulation by the agencies on the basis of the IOSCO Code, were sufficient to address all major issues of concern in relation to CRAs (see European Commission 2006).

Against this backdrop, the CESR (2006) and the European Securities Markets Expert (ESME) Group (2008)—both on behalf of the European Commission—presented proposals that appeared to show a way to keep up the required pressure.

On top of this, however, CRAs are also regulated directly in the EU by the Capital Requirements Directive, which implements Basel II in Europe. In practice, only the big three agencies are affected.

[7] See Securities Exchange Acts of 1934 Art. 15E (2).

[8] The ten agencies: A.M. Best Company, Inc.; Dominion Bond Rating Service Ltd.; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Moody's Investor Services, Inc.; Rating and Investment Information, Inc.; Standard & Poor's Rating Services; Egan-Jones Rating Company; LACE Financial Corp.; and Realpoint LLC.

To be recognized as an external credit assessment institution (ECAI) under the standardized approach of the Basel II Capital Framework, an agency's rating methods must satisfy criteria set by supervisors concerning objectivity, independence, continuous monitoring, and transparency. ECAI recognition is a prerequisite for banks being able to use the agency's ratings to calculate their risk-weighted assets in accordance with the Capital Requirements Directive. A CRA may be recognized by supervisors if its rating methodology meets the following requirements:

- ratings must be objective—the methodology used must, in particular, be systematic and subject to some form of validation;
- the process should be free from political influence and economic pressure;
- ratings should be reviewed at least once a year; and
- general information about the methodology should be documented and publicly available.

It must be possible for supervisors to monitor the frequency with which methodologies are reviewed (see Everling and Trieu 2007: 109).

In addition, ratings

- should be judged credible and reliable by users, and
- should be available to all institutions with a legitimate interest in them on the same terms.

These criteria do not interfere in the methodologies used by CRAs but are general quality standards, which are admittedly monitored. They apply solely for prudential purposes.

6. POLITICAL DEMANDS AND CONCLUSIONS IN LIGHT OF THE FINANCIAL CRISIS

Market participants' appeals to continue to rely on the ability of CRAs to regulate themselves were partially taken on board by those in positions of political responsibility. Though state regulation was called for, this was to be based on the IOSCO Code. On 29 January 2008, for example, a joint communiqué by the leaders of France, Germany, Italy, and UK and the President of the European Commission called for "… improvements in the information content of credit ratings to increase investors' understanding of the risks associated with structured products, and for action to address potential conflicts of interests for rating agencies. While preferring market-led solutions, such as the amendment of the IOSCO Code of Conduct, if market participants prove unable or unwilling to rapidly address these issues we stand ready to consider regulatory alternatives" (Office of the Prime Minister of the United Kingdom, 2008).

At a relatively early stage, therefore, policymakers put pressure on the CRAs to propose concrete improvements and demonstrate that steps were being taken to eliminate shortcomings. Some governments, however, most notably that of France, went as far as to demand that CRAs be tightly regulated.

And as the financial crisis deepened, the will to regulate became increasingly entrenched. The foundations for regulatory measures were laid by the G-20 summits in Washington, DC and London. In the final declaration of the Washington summit, the participants stated: "We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct" (G-20 2008). In the view of the G-20 leaders, the objective of state regulation was to prevent conflicts of interests. The G-20 resolutions published in London on 2 April 2009 fleshed out the steps to be taken and made them more

binding by setting an implementation deadline. By the end of 2009, for example, a system of supervising and registering CRAs was to be established in all G-20 states (G-20 2009).

Both before and after the G-20 summits, various national and international bodies put forward a number of proposals reflecting an astonishingly broad range of potential forms of regulation.

In Germany, the Issing Committee (2008) proposed measures in the following areas:

- Rating performance should be monitored by regulators, applying high statistical standards. Rating performance relative to outcomes should be published regularly (e.g., annually).
- To minimize rating shopping, unsolicited ratings should be encouraged (e.g., by mandatory rating disclosure).
- The use of structured finance ratings in public regulation, e.g., Basel II or consumer protection regulation, should be reconsidered (and dropped if necessary) in order to limit the pressure on CRAs.
- Agencies should be encouraged to adjust their rating methodology to innovations in the financial industry, e.g., to flag structured finance ratings or reveal incentive alignment and first loss piece retention as part of rating information.
- Rating fees should be linked to rating performance.
- An annual report on rating practices and rating competition by a central oversight body might help both to monitor market quality and draw attention to outstanding analytical uncertainties of which investors might be unaware.
- The activities of CRAs should be monitored, among other things by implementing a code of conduct.

Ahead of the G-20 London summit, the Issing Committee (2009) went a step further and proposed, in addition, that

- internationally active rating agencies should be registered with an institution entrusted with capital market oversight, e.g., the International Monetary Fund (IMF) or Bank for International Settlements (BIS);
- on a regular basis, agencies should deposit their rating assessments with the entrusted institution, which should undertake a thorough statistical analysis of this data and publish regular rating default and rating migration tables;
- these assessments should be disclosed to markets and investors; and
- a high-level, open annual event should discuss the status of the rating industry and its performance. The use of designated expert panels in a public dialogue with issuers, investors, and regulators should help to maintain the right level of awareness and to stimulate regulatory and industry debate about rating practices.

While the Issing Committee recognized that only globally consistent regulation would improve the stability and efficiency of the international financial markets, the de Larosière Report sought to provide the European Commission with a basis for the EU Regulation on Credit Rating Agencies, which was already under preparation. The report's recommendations were as follows (de Larosière Group 2009):

- CRAs must be regulated effectively to ensure that their ratings are independent, objective, and of the highest possible quality.
- The CESR should be entrusted with the task of licensing and supervising CRAs in the EU.

- A fundamental review of CRAs' economic models should be conducted, notably in order to eliminate the conflicts of interests that currently exist. The modalities of a switch from the current "issuer pays" model to a "buyer pays" model should be considered at the international level.
- Consideration should be given to the ways in which the formulation of ratings could be completely separated from the advice given to issuers on the engineering of complex products.
- The use of ratings required by some financial regulations should be significantly reduced over time.
- Regulators should keep a close eye on the performance of CRAs with the recognition and allowable use of their ratings made dependent on their performance. CESR should, on an annual basis, approve those CRAs whose ratings can be used for regulatory purposes. Should the performance of a given CRA be insufficient, its activities could be restricted or its license withdrawn by CESR.
- The rating of structured products should be changed, with a new, distinct code alerting investors to the complexity of the instrument.
- Supervisors should check that financial institutions have the capacity to complement the use of external ratings (on which they should no longer excessively rely) with sound independent evaluations.[9]

Early 2009 also saw concrete proposals on regulating CRAs emerge from the UK. The Turner Review, which set out the proposals of the UK Financial Services Authority (FSA) for ensuring a stable global banking system, included some recommendations concerning CRAs. Basically, the FSA supported the main points of the European Commission's draft regulation. In addition, it saw a need to ensure that ratings were only used for purposes to which they were suited. In particular, the FSA (2009: 78) took the view

- that the rating agencies themselves should improve communication relating to the purpose of ratings, emphasizing that they cannot be treated as carrying inferences for liquidity and price; and that
- public policy should avoid unnecessary requirements for investing institutions to hold securities of a specific rating.

At the same time, the FSA warned against undue expectations of what regulation could achieve. It pointed out, in particular, that regulating CRAs would have only limited success in reducing the procyclical impact of prudential rules. While changes in regulatory policy relating specifically to rating agencies had an important role to play, the FSA nevertheless believed that other factors might have a bigger influence on the use of ratings and on the extent to which procyclical dangers could be offset.

As well as advocating state regulation of CRAs, policymakers also called for more competition in the industry. Especially popular among German politicians is the idea of establishing a European CRA as a counterweight to the Anglo-Saxon agencies currently dominating the market. This proposal has been discussed in Germany for many years and has most recently been touted at the highest level as a solution to the shortcomings displayed by CRAs in the financial crisis. Not only Finance Minister Peer Steinbrück, but also Chancellor Angela Merkel has championed the plan.

In summer 2008 Chancellor Merkel told the *Financial Times* (2008): "Europe has developed a certain independence thanks to the euro [but] in terms of the rules, the transparency guidelines and the entire standardisation of financial markets, we still have a strongly Anglo-

[9] For proposals on a far-reaching extension of CRA regulation, see also Partnoy (2009).

Saxon-dominated system … I think that in the medium term Europe will need a working rating agency because the robust currency system of the euro has not yet secured sufficient influence over the rules governing financial markets."[10]

There was some amount of European agreement on this point. At the beginning of the financial crisis, the French Finance Minister Christine Lagarde also called for a European alternative to existing CRAs. Germany even made a proposal at the G8 summit in Japan to establish a European CRA to compete with market leaders Moody's and Standard & Poor's. And while debating the European Commission's proposal for a Regulation on Credit Rating Agencies, the European Parliament discussed various legislative options for forcing investors to use ratings issued by a European credit rating agency.

The idea of a European CRA first needs to be assessed against the objective of encouraging competition in an oligopolistic market. Given the mistakes made by the CRAs in rating structured products, calls for more reliable ratings were inevitable. In a "normal" market, improvements in quality are driven by competition. Demands for additional CRAs to compete with the players dominating the market are therefore understandable. It is unlikely, however, that competition to provide the best quality can be achieved by means of a European rating agency protected and supported by European regulation. This is not the way to promote the emergence of a strong competitor. The notion that such an agency would issue better (and more Europe-friendly) ratings is based on a fundamental misconception about the role and functioning of CRAs.

Contrary to policymakers' intentions, the creation of a European CRA could result in investors considering the ratings of European companies and structured finance products to be of lower quality than the ratings of companies in other regions. This would have an adverse effect on the funding opportunities and costs of European firms and would weaken the EU financial market. An inappropriate attempt of this kind to boost competition in the ratings market could thus damage the reputation of credit ratings as a whole and fly in the face of the actual objective of state regulation.

7. REGULATORY MEASURES INTRODUCED DURING THE FINANCIAL CRISIS

7.1 Revision of the IOSCO Code

The financial crisis led financial regulators to conclude that provisions of the IOSCO Code were inadequate. As a result, the Code was fundamentally revised in 2008. The changes made were intended to address issues that arose in relation to the activities of CRAs in the market for structured finance products. Although the IOSCO Code still contains no specific rules concerning methodologies, it now sets out extensive disclosure requirements aimed at enabling both investors and regulators to gain better insight into ratings and avoid an excessive reliance on CRAs at the expense of their own judgment. The main changes in the revised Code are as follows (see IOSCO 2008a).

To protect the **quality and integrity of the rating process**, CRAs should:

- prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates;
- ensure the quality of the information needed for ratings and inform users about the limitations of the rating;
- periodically review the methodologies and models they use;

[10] In June 2009 the German Federal President demanded in a speech a European public rating agency. See Köhler (2009).

- ensure that the decision-making process for rating action is conducted in an objective manner;
- ensure that rating analysts have appropriate knowledge and experience;
- establish procedures to review the feasibility of providing ratings for new structures;
- ensure that methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially; and
- ensure that adequate resources are allocated to monitoring and updating their ratings.

To ensure **CRA independence and avoidance of conflicts of interests**, CRAs should:

- state whether issuers will publicly disclose all relevant information about the product being rated;
- disclose whether any client accounts for more than 10% of the CRA's annual revenue;
- review the past work of analysts that leave the CRA;
- review remuneration policies to ensure the objectivity of the CRA's rating process; and
- define what they do and do not consider to be an ancillary business and why.

Regarding their **responsibilities to the investing public and issuers**, CRAs should:

- publish historical information about the performance of their rating opinions;
- differentiate ratings of structured finance products from other ratings, preferably through different rating symbols;
- indicate the attributes and limitations of each credit opinion;
- provide investors with sufficient information so that an investor can understand the basis for the CRA's rating; and
- disclose the principal methodology or methodology version used in determining a rating.

This was not the end of the response to the financial crisis by international supervisors, however. At the end of July 2008, IOSCO (2008b) published a statement announcing that a task force would explore possible cooperation between its members with the aim of ensuring that CRAs disclosed information in the due and complete form envisaged by the IOSCO Code. The tightening of regulatory requirements culminated in the following announcement in September: "IOSCO favours a consistent global regulatory approach to monitoring the activities of CRAs. It urges legislators to consider the regulatory consensus represented by the IOSCO Code of Conduct when framing legislation as any fragmentation runs the risk of a recurrence of problems with product ratings" (IOSCO 2008c). Financial supervisors thus paved the way for the formal regulation of credit rating agencies.

7.2 Revision of the Credit Rating Agency Reform Act

In the US, the SEC sought during the financial crisis to further improve the regulation of CRAs. In June 2008, it released a report outlining serious deficiencies in the ratings process. It subsequently adopted new rules designed to increase the transparency of NRSRO rating methodologies, strengthen NRSRO disclosures of ratings performance, prohibit certain NRSRO conflicts of interests, and enhance NRSRO recordkeeping. NRSROs were required

to start making publicly available their rating histories in the form of a random sample of 10% of issuer-paid ratings for each class of ratings.

At the end of 2008, building on earlier rulemakings, the SEC adopted requirements to enhance NRSRO transparency and further address potential NRSRO conflicts of interests (see SEC 2008b). It also proposed additional rules (see SEC 2008c), which were introduced in April 2009.

7.3 Measures in the EU

After the outbreak of the financial crisis, the European Commission asked CESR to prepare a report on problems associated with credit ratings. CESR was instructed to focus on the following issues:

- the transparency of rating methodologies,
- number and expertise of staff at CRAs,
- regular monitoring of ratings and topicality of rating actions, and
- potential conflicts of interests (e.g., remuneration schemes at CRAs).

In addition, the Commission requested ESME to examine credit ratings in the securities market. CESR (2008) made the following recommendations on regulating CRAs:

- The IOSCO Code should be a minimum standard.
- An international body should be established to set standards for CRAs on the basis of the IOSCO Code and monitor compliance. The names of CRAs deviating from the Code should be made public ("name and shame"). Issuers, investors, and investment firms should be represented on the body. CRAs' participation in this body should be limited to involvement in drawing up the standards. Members of the body should be appointed by the international supervisors to which the body would report.
- CRAs should deliver the necessary information.
- If this international body cannot be set up at short notice, a European authority reporting to CESR should be established.
- Only if market participants fail to provide the necessary support or if the body is unable to adequately ensure the integrity and transparency of ratings should financial supervisors consider further measures, including regulation.
- The European Commission should set the process in motion as soon as possible. In the event of undue delay, regulatory action should be taken.

In its report, CESR (2008: 3) concluded that: "there is no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings of US subprime backed securities and [CESR] hence continues to support market driven improvement."

CESR nevertheless took the view that greater commitment was required on the part of market participants and CRAs if the necessary discipline was to be ensured. It also pointed out that the use of ratings for regulatory purposes could result in excessive confidence being placed in ratings.

The IOSCO Code remained the relevant benchmark for the credit rating industry, although CESR now considered it merely a minimum standard on which to base an extended model aimed essentially at refining and enforcing the Code.

ESME (2008) believed that the CRAs themselves had to solve the problem of the loss in confidence. It saw no regulatory magic bullet. On the contrary, full, formal regulation might

result in credit ratings being trusted to a point that could not possibly be justified. ESME therefore recommended revising the IOSCO Code and adding provisions to remedy the problems that had come to light in the rating of structured finance products. In addition, ESME recommended that the Code be complemented by the external monitoring of CRAs' corporate governance, and that an advisory group be set up to report to CESR.

8. THE EU REGULATION ON CREDIT RATING AGENCIES

At the political level, developments in the EU fast outpaced the recommendations of CESR and ESME. The end of July 2008 saw the European Commission launch consultations on regulating CRAs and this was followed in November 2008 by the publication of a proposal for an EU regulation. After controversial discussions in the European Parliament and the European Council, the Regulation on Credit Rating Agencies was adopted by the Parliament on 23 April 2009, approved by the Council of Ministers on 5 May and now applies directly in all member states (European Parliament 2009).

The Regulation contains some provisions that are also to be found in the IOSCO Code but that are now legally binding. On the other hand, some important points of the Code have not been incorporated into the EU Regulation. This is unfortunate because it is unclear what role the IOSCO Code should now play in the EU. It is not intended that the Regulation should replace the established process of recognizing ECAIs. The ECAIs already recognized in the EU should apply for registration in accordance with the Regulation (European Parliament 2009: Article 2a).

A registration procedure has thus been introduced that will enable European supervisors to monitor the activities of CRAs. The primary objective of the Regulation is to avoid the existing and potential conflicts of interests between CRAs and the organizations they rate.

The key points of the Regulation are:

1. **Scope**

   Credit institutions (i.e., banks) may only use "for regulatory purposes" ratings that have been issued by a CRA that is registered within the EU, or satisfies the equivalence criteria in the Regulation.

2. **Registration and supervision of CRAs**

   The Regulation establishes a mechanism for CRAs to be registered with their home member states' competent authorities, and for their EU affiliates to be supervised through a "college of supervisors" coordinated and moderated through the CESR.

3. **Equivalence and endorsement**

   For recognizing the ratings of instruments and entities given by CRAs outside of the European Community:

   (a) Registered CRAs can endorse the ratings of entities or instruments given by their affiliates outside of the European Community provided that (among other things)

      (i) the registered CRA can verify on an ongoing basis that the conduct of the third-country CRA operates under a no-less-stringent supervisory regime;

      (ii) there is an objective reason for the rating to be performed in the third country rather than within the European Community; and

      (iii) there is an "appropriate" cooperation agreement in place between the national regulator of the registered CRA and the third-country CRA's regulator. This way multinational CRAs may be able to

endorse within the EU the ratings given by their foreign affiliates, although it is critical that the Commission publishes a list of third countries with which such cooperation arrangements have been made.

(b) Ratings of third-country CRAs relating to third-country instruments or entities may be used by credit institutions for regulatory purposes provided that (among other things)

(i) there is a cooperation agreement between the Commission and the third-country regulator in effect;

(ii) the European Commission has adopted an "equivalence decision" confirming that the standards of regulation in the third country are equivalent to EU standards; and

(iii) the third-country CRA has been "certified" by CESR.

4. Withdrawal of registrations and transition periods

If a CRA's home regulator withdraws that CRA's registration, there will be a transition period during which the CRA's ratings of any investments or entity may still be used by credit institutions for regulatory purposes. This period is:

(a) ten working days where the rated investment or entity is also rated by a different registered CRA; or

(b) three months otherwise—a period that may be extended by the Commission in circumstances where there is "potential for market disruption or financial instability."

5. Structured finance

Structured finance instruments will have some sort of an "additional symbol" to distinguish them from other rating categories. CRAs will also be required to disclose information about the due diligence processes they have performed, loss information and cash-flow analysis, their assumptions, and the stress scenario simulations they have undertaken.

There is a further restriction on the issuance of ratings for complex products: "where the lack of reliable data or the complexity of the structure of a new type of financial instrument or the quality of information available is not satisfactory or raises serious questions as to whether a credit rating agency can provide a credible credit rating, the credit rating agency shall refrain from issuing a credit rating or withdraw an existing rating."

6. CRA internal governance and transparency

The Regulation imposes standards of internal governance to ensure (among other things) that CRAs manage any conflicts of interests, have independent compliance departments, and review their rating methodologies periodically.

Additionally, the analysts or persons who approve ratings must not "make proposals or recommendations, whether formally or informally, regarding the design of structured finance instruments on which the credit rating agency is expected to issue a credit rating."

CRAs are now subject to extensive disclosure requirements. They have to disclose their models, methodologies, and the basic assumptions on which their ratings are based. They must demonstrate that they have carried out their assessments on the basis of all the information available from reliable sources. An annual transparency report must also be published detailing not only their financial figures but also their systems of rotation.

> Their supervisory or administrative board must include at least two independent members whose remuneration is not linked to the CRA's performance. At least one member must be an expert on securitization and structured finance instruments.
>
> The Regulation also sets periods during which former analysts may not take up certain positions within entities that they have rated.

The fact that banks are required to use the ratings of registered CRAs only for regulatory—and not for wider—purposes is a favorable outcome for the banking industry. Earlier drafts of the Regulation envisaged that a potentially much broader scope of banking activities would require the use of ratings issued by registered CRAs. By linking the use of ratings issued in accordance with the Regulation to regulatory purposes (meaning compliance with European Community law), the scope is more clearly defined.

Registration standards are maximum harmonization measures, meaning that no member state can impose threshold requirements in addition to, or higher than, those set out in the Regulation. Given the purpose and scope of the Regulation, this is appropriate.

The endorsement approach is aimed at larger CRAs, and the equivalence approach at smaller CRAs without a group presence in the EU. While it is helpful in principle to set out a regime for recognizing third-country ratings equivalence, it is not yet clear how endorsement criteria will be satisfied or what the exact procedure will be for concluding cooperation agreements and making equivalence decisions. Nor is it completely clear what constitutes "equivalence." In particular, the substantive requirements of the Regulation—against which equivalence will be judged—are more detailed and extensive than the international IOSCO Code of Conduct. This may restrict the ability of CRAs to obtain equivalence rulings.

The idea of an additional symbol proposal has been floated for some time; the IOSCO Final Report of May 2008 included a similar proposal. Politically desirable as it may be, this requirement may confuse investors and suggest that there is some qualitative difference between structured finance and other ratings. For regulatory capital purposes—i.e., determining the applicable credit quality step assigned to a rating—the additional symbol is unlikely to make a difference.

This raises the question as to what the additional symbol will achieve. If the credit quality of a structured product is inferior, why should this not be reflected in a lower rating? And if it is not inferior, why do we need the additional symbol? Certainly, one of the overall challenges for regulators is to ensure that published ratings capture qualitative differences between various types of rated entities or instruments. Given that structured instruments are fundamentally different from corporate bonds and behave in very different way, the additional symbol may be seen as part of the response to this challenge.

While it is possible that the additional disclosure requirements for structured finance instruments may help some investors in their investment decisions, they may also serve to diminish investor appetite for such instruments. The concern is that, having been provided with this additional information, some investors may balk at the idea of spending the extra time and effort needed to review it. Furthermore, although it may seem common sense and sound business practice for CRAs not to issue ratings if the complexity of the instrument or amount of available information does not permit satisfactory analysis, enshrining this point in the Regulation may have the effect of stifling financial innovation.

From the banks' point of view, the final version of the Regulation contains a number of improvements on the initial proposals and drafts. These include the restriction of the Regulation's scope to ratings used for regulatory purposes, the twelve-month window before regulatory capital will be affected, and the transitional arrangements so that ratings can continue to be used temporarily if registration is revoked. For CRAs, the Regulation imposes an additional administrative, disclosure, and supervisory burden; for agencies that already comply with the IOSCO Code, however, the adjustments required to be Regulation-compliant may be less onerous than those they have already carried out. For third-country

CRAs looking to do business in the EU, and for EU banks wishing to buy securities rated only by third-country CRAs, the Regulation's impact may be considerably harsher.

9. WHAT REMAINS TO BE DONE?

The responsibility borne by credit rating agencies (CRAs) for the financial crisis has been analyzed in depth by policymakers and various expert groups over the last eighteen months. Some of the proposed reforms went much further than the changes set out in the European Union Regulation on Credit Rating Agencies. Expectations of the Regulation's impact should therefore not be unduly high. Policymakers are well aware of this and see the Regulation's primary objective as being to address the problem of conflicts of interests. As things stand, there is a good chance that this can be achieved.

Given the limited scope of the selected approach, however, it is clear that it can only make a qualified contribution to stabilizing the financial system, namely in areas where the instability has been caused by conflicts of interests or general corporate governance problems. Key issues, such as the lack of competition in the ratings market, liability, and, above all, the procyclical impact of credit ratings, remain unresolved. It would go far beyond the scope of this paper to present detailed proposals for their solution. Instead, these concluding remarks will confine themselves to outlining which approaches appear the most promising from the perspective of the banks in Germany.

While we are unlikely to see any meaningful proposals on liability beyond emphasizing the importance of ensuring that every single rating issued is of the highest possible quality, this does not apply to the other two issues mentioned. True, there is no simple solution to either problem. Competition between CRAs is desirable as it encourages high-quality ratings and their continuous improvement. Promoting more competition will be far from easy, however. The obstacles to entering the market are clearly extremely high. But facilitating market entry by offering political support for a European credit rating agency, for instance, would do little to boost quality through competition. The same goes for political intervention in the form of rules requiring a certain proportion of ratings to be issued by national or regional CRAs.

One obstacle to more competition is the issue of who should pay for a rating. The current tight oligopoly is unlikely to be broken up under the existing "issuer pays" system because neither issuers nor CRAs have an interest in more ratings. Nevertheless, switching to an "investor pays" model should not in itself be expected to produce a quick fix. Whereas in the "issuer pays" model competition can lead to inflated ratings because the company chooses who should rate them, in the "investor pays" model there is a free rider problem, and it is not clear how the free market can resolve it. This dilemma could, however, be solved by decoupling the competition problem from the ratings market. The service required is an assessment of credit quality or the risk of default. A credit rating is only one of the instruments capable of performing this task. Credit default swaps, for example, fulfill a comparable function from an alternative starting point. If the relevant market is defined in this way, financial market regulation itself will automatically have a direct role to play in enhancing competition because by using ratings to regulate banks it contributes directly to the reduction in competition.

Registration as nationally recognized statistical rating organizations or external credit assessment institutions places CRAs in a position of unqualified authority as the central source of information about the creditworthiness of bonds and structured finance products. This makes it clear that the competition problem is directly linked to the extent to which the regulatory use of ratings has exacerbated procyclicality in the financial system as a whole. The problem cannot therefore be resolved by increasing competition solely between CRAs but, above all, by seeking alternative approaches to assessing risk for regulatory purposes and thus for the purposes of determining capital requirements. Such a strategy has the potential to gradually reduce the role played by credit ratings in regulating the financial

markets. The need to reduce the dependency of regulations and supervisory practices on ratings is also seen by the US Treasury (2009).

A different three-step approach to reduce procyclicality has been proposed by the International Monetary Fund. As a first step, policymakers should have a good grasp of the risk inherent in credit ratings. “Ratings maps” can offer a template for policymakers to identify the different channels through which rating downgrades can lead to systemic risk. Second, policymakers will need to measure risks inherent in ratings once they are identified. A useful method to measure the systemic exposure to downgrade risk during boom cycles would be for regulators and institutions to stress test their balance sheet and off-balance sheet positions. And finally, systemic institutions that are vulnerable to abrupt ratings downgrades may have to hold more capital or liquidity buffers (Sy 2009).

Naturally, this call to seek alternative approaches to assessing credit quality is also addressed to investors. They should decrease their dependency on ratings by basing their investment decisions on a broader range of indicators. This could reduce the risk of ratings downgrades being followed by mass selling, write-downs, and additional capital requirements. The most promising indicators to consider would be those that reflect a deterioration in credit quality more swiftly than is the case with credit ratings.[11]

[11] For an in-depth discussion of these problems and for concrete proposals, see Partnoy (2009) and Dittrich (2007).

REFERENCES

Blaurock, U. 2007. Control and Responsibility of Credit Rating Agencies. *Electronic Journal of Comparative Law* 11(3). http://www.ejcl.org/113/article113-16.pdf (accessed 25 June 2009).

Committee of European Securities Regulators (CESR). 2005. CESR's technical advice to the European Commission on possible measures concerning credit rating agencies. Ref: CESR/05-139b. Paris: CESR.

———. 2006. CESR's Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code. Ref: CESR/06-545. Paris: CESR.

———. 2008. CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance. Ref: CESR/08-277. Paris: CESR.

de Larosière Group. 2009. Report of The High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière. Brussels, 25 February.

Deutscher Bundestag. 2003. Transcript of a public hearing of the German Parliament's Finance Committee on 4 June 2003. http://webarchiv.bundestag.de/archive/2005/0825/parlament/gremien15/a07/protokolle/Protokoll_020.pdf (accessed 25 June 2009).

———. 2007. Parliamentary Paper 16/7191. http://dokumente.linksfraktion.net/drucksachen/7730352544_1607191.pdf (accessed 25 June 2009).

Dittrich, F. 2007. The Credit Rating Industry: Competition and Regulation. Cologne. http://ssrn.com/abstract=991821 (accessed 25 June 2009).

Emmenegger, S. 2006. Die Regulierung von Rating-Agenturen [The Regulation of Rating Agencies]. SZW/RSDA 1/2006: 32–41.

European Securities Market Expert Group (ESME). 2008. Role of Credit Rating Agencies. ESME's report to the European Commission. Brussels: ESME.

European Parliament. 2009. Regulation of the European Parliament and of the Council on Credit Rating Agencies.

Everling, O., and M. L. Trieu. 2007. Ratingagenturen weltweit [Rating Agencies All Over the World]. In *Handbuch Rating* [A Credit Rating Compendium], 2nd edition, edited by H. E. Büschgen and O. Everling. Wiesbaden: Gabler.

European Commission. 2006. Communication from the Commission on Credit Rating Agencies. *Official Journal of the European Union* C 59/2. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:059:0002:0006:EN:PDF (accessed 25 June 2009).

Financial Services Authority (FSA). 2009. The Turner Review, A Regulatory Response to the Global Banking Crises. London: FSA.

Financial Stability Forum. 2008. Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience. http://www.financialstabilityboard.org/publications/r_0804.pdf (accessed 25 June 2009).

Financial Times. 2008. Interview with Chancellor Angela Merkel 11 June 2008. http://www.ft.com/cms/s/0/bb9ca588-374f-11dd-bc1c-0000779fd2ac.html?nclick_check=1 (accessed 25 June 2009).

Group of Twenty (G-20). 2008. Declaration of the Summit on Financial Markets and the World Economy. Washington, DC: G-20. http://www.g20.org/Documents/g20_summit_declaration.pdf (accessed 25 June 2009).

———. 2009. Declaration on Strengthening the Financial System. London: G20. http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf (accessed 25 June 2009).

Gonzalez, F. et al. 2004. Market Dynamics Associated with Credit Ratings: A Literature Review. Occasional Paper Series No. 16. Frankfurt: European Central Bank.

Hill, C. A. 2004. Regulating the Rating Agencies. Washington, DC: Georgetown University Law Center. http//ssrn.com/abstract=452022 (accessed 25 June 2009).

International Organization of Securities Commissions (IOSCO), Technical Committee. 2004. Code of Conduct Fundamentals for Credit Rating, IOSCO Public Document 173 (October 2004). Madrid: IOSCO. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD173.pdf (accessed 25 June 2009).

———. 2008a. Code of Conduct Fundamentals for Credit Rating Agencies, revised May 2008. Madrid: IOSCO.

———. 2008b. IOSCO Announces Next Steps on Credit Rating Agencies. Press release 28 July 2008. Madrid: IOSCO. http://www.iosco.org/news/pdf/IOSCONEWS124.pdf (accessed 25 June 2009).

———. 2008c. IOSCO Urges Greater International Coordination in the Oversight of Credit Rating Agencies. Press release 17 September 2008. Madrid: IOSCO. http://www.iosco.org/news/pdf/IOSCONEWS126.pdf (accessed 25 June 2009).

Issing Committee. 2008. New Financial Order: Recommendations by the Issing Committee, Part I (October 2008) Preparing G-20 – Washington, November 15, 2008: Frankfurt: Center for Financial Studies. http://www.ifk-cfs.de/fileadmin/downloads/publications/white_paper/White_Paper_No_1_Final.pdf (accessed 25 June 2009).

———. 2009. New Financial Order Recommendations by the Issing Committee, Part II (March 2009), Preparing G-20 – London, April 2, 2009. Frankfurt: Center for Financial Studies. http://www.ifk-cfs.de/fileadmin/downloads/publications/white_paper/White_Paper_No_2_2009_Final.pdf (accessed 25 June 2009).

Köhler, H. 2009. Grußwort bei der Festveranstaltung "125 Jahre Deutscher Sparkassen und Giroverband" [Welcome speech at a function celebrating 125 years of the Deutscher Sparkassen- und Giroverband (German Savings Banks Association)]. Berlin. http://www.bundesregierung.de/nn_1514/Content/DE/Bulletin/2009/06/73-1-bpr-sparkasse.html (accessed 25 June 2009).

Office of the Prime Minister of the United Kingdom. 2008. Joint Communiqué on the Global Economy. 29 January. http://www.number10.gov.uk/Page14443 (accessed 25 June 2009).

Partnoy, F. 2009. Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective, White Paper for the Council of Institutional Investors. Washington, DC. http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf (accessed 25 June 2009).

Securities and Exchange Commission (SEC). 2008a. Annual Report on Nationally Recognized Statistical Rating Organizations. Washington, DC: SEC.

———. 2008b. Amendments to Rules for Nationally Recognized Statistical Rating Organizations. Washington, DC: SEC. http://sec.gov/rules/final/2009/34-59342.pdf (accessed 25 June 2009).

———. 2008c. Re-proposed Rules for Nationally Recognized Statistical Rating Organizations. Washington, DC: SEC. http://sec.gov/rules/proposed/2009/34-59343.pdf (accessed 25 June 2009).

Spiegel-Online. 2009. Zock-Stopp für die Weltwirtschaft [Gambling-Stop for the World Economy]. *Spiegel-Online*. http://www.spiegel.de/wirtschaft/0,1518,623653,00.html (accessed 25 June 2009).

Sy, A. N. R. 2009. The Systemic Regulation of Credit Rating Agencies and Rated Markets. IMF Working Paper 09/129. Washington, DC: IMF.

US Congress. 2006. Credit Rating Agency Reform Act of 2006. Washington, DC.

US Treasury. 2009. Financial Regulatory Reform: A New Foundation. Washington, DC.