Master thesis

Credit rating agencies: a comparative approach of legislation between the US and the EU

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ABSTRACT

Credit rating agencies have become an important part of the financial market. The use of ratings and the role they play in today's financial market is significant. The current Euro crisis but also earlier periods of crisis have all contributed to the current discussion about the role and capabilities of credit rating agencies in the financial market.
Credit rating agencies have remained unregulated for a long time, but this has been changed rapidly. Regulation of rating agencies has had an enormous boost in the last couple of years.
The question often asked in public debates is whether national legislators should build stronger, more extensive legislation in order to get a grip on rating agencies and their activities. The European and U.S. legislators are still struggling with the failures of and the criticism on these agencies, and with them many more countries around the world.

The main focus of this thesis is the development of legislation and current issues with regard to credit rating agencies in the United States and in the European Union. The approach of both regimes will be compared and current issues and solutions proposed by both legislators are described and commented. It can be concluded that the United States legal and supervisory framework can be considered broadly identical to the European regulatory regime for credit rating agencies, although there are several differences in the formation of legislation. Both regimes have several identical issues with regard to rating agencies on their agenda but there are also issues that have more attention in a specific regime such as the discussion on sovereign ratings in Europe. The European and U.S. legislators however mostly react to upcoming issues with regard to credit rating agencies by creating new proposals and therewith by using legislation, alternative solutions are hardly being developed. The actions of both regimes can be labeled as defensive and reactive instead of proactive and forward thinking with a long-term strategy.

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INTRODUCTION

Although not everyone might know what rating agencies exactly do, many people are without a doubt in a way familiar with some of their names and actions as these rating agencies were very often in de media in the last couple of months and years. Recently Moody's and Standard & Poor's made the headlines as a result of their downgrading of South-European countries like Greece and Portugal. More and more critique is expressed lately through the media, by for example economists and politicians, when it comes to these activities of rating agencies. According to some, credit rating agencies have become too powerful and their actions have very large effects on the financial systems and the capital markets. Others claim that our financial system cannot do without these rating agencies anymore and are of the opinion that their rating activities also have many advantages.

In the last couple of months we have seen several European politicians who have expressed their concerns with regard to the sovereign ratings in the media, but the discussion concerning credit rating agencies and their activities is not only a hot topic in Europe. The United States is also struggling with the critique concerning these agencies, and with them many more countries around the world. The discussion about these rating agencies and their activities can therefore be labeled as universal. It is a diverse discussion with many different aspects, which is influenced not only by many recent events such as the recent Euro crisis, but also by many events in the past like the financial crisis of 2007 in the United States. The discussion is further complicated by the agencies lack of opacity and the, at least for outsiders, often difficult to understand financial environment in which these firms operate.

The question often asked in public debates is whether national legislators should build stronger, more extensive legislation in order to get a grip on rating agencies and their activities. At the same time it is not sure that additional legislation will comfort all the concerns surrounding credit rating agencies.

Besides international general guidelines, the legislative approach towards credit rating agencies is mostly coming from national legislators, in Europe however the European legislator takes the lead in this regard. In this research the legislation discussion with regard to credit rating agencies in the United States will be compared with developments in Europe. Goal of this comparison is firstly to get a better view on whether the approaches of both regimes are either similar or different and secondly whether both regimes signal the same issues or have different focus areas. Finally an opinion is given about possible alternatives that can be used to reduce discussed issues besides creating more or better legislation.

It might be strange at first to compare a country (the United States) on national level with group of countries (Europe) on regional level, however the United States and Europe are the two most important regions to observe when exploring the developments with regard to the approach in regulation of rating agencies. Most of the recent developments in legislation on credit rating agencies took part at the level of the European Union so the developments at that level will be compared with the developments in the United States. This research method that is used for this thesis is literature study. The main focus of this research is the development of legislation and current issues with regard to credit rating agencies in the United States and in the European Union. Therefore no political of economical aspects will be treated unless they contribute to the clarity and a better understanding of the legislator aspects.

The following research question was formulated for this research:

Why and how do the American and European legislators try to get more control over credit rating agencies; can they learn from each other, and are there alternatives besides more (national) legislation?

Chapter 1 will give an introduction into the background of credit rating agencies and will explore why, and how important credit rating agencies are for our financial system. Chapter 2 will give an insight into the issues with regard to credit rating agencies that are currently on the agenda of the European and United States legislator. It furthermore tries to find an answer to the question why both regimes want more control over credit rating agencies. The differences in the American and European approaches in legislation towards rating agencies are addressed in Chapter 3. Chapter 4 lastly explores whether there are alternatives besides additional legislation to get more grip on rating agencies and contains conclusions and recommendations.

1 THE IMPORTANCE OF CREDIT RATING AGENCIES FOR OUR FINANCIAL SYSTEM

It seems that credit rating agencies are nowadays more in the news than ever. It is almost impossible to read the paper or watch the news without running across an article or an announcement concerning these agencies or their ratings at least once a week. But what are credit rating agencies exactly, what do they do and where do they come from? This first chapter will give a brief insight into the world of credit rating agencies from an international perspective. It will describe the background of the largest rating agencies that we know nowadays, and it will furthermore go into detail with reference to the agencies' activities, their approach when it comes to rating a specific object and will explain more about users of ratings. By describing the activities and explaining the importance of credit ratings for our financial system, the following question will be answered: „how important are credit rating agencies for our financial system?

1.1 BACKGROUND

Although rating agencies seem to have suddenly popped out of nothing in the past couple of years, they are certainly not a new phenomenon. The first rating agency (an agency that comparably to the ones known today) was already established in 1909 in the United States by John Moody.[1] He published a book and his first rating schemes in that year, but not that many people were interested. It took until the 1920's before real growth occurred. At that time rating agencies made money by subscription fees. They provided ratings to parties that subscripted themselves and paid for this service. Issuers were not charged.[2]

But even before the establishment of credit rating agencies there were already decades of activity on the bond markets in the United States, for example to finance the railroad activities in that country. In Europe common stock was invented 300 years earlier in 1609 by the Dutch, and the government bond market existed at that time for decades already, all without the presence of credit rating agencies. This was possible because in the early stages of bond financing and securities trading mostly public bonds were used. Investors trusted and relied on the governments, but later on when the market grew and became international most capital needs were covered by the issuance of shares or bank loans.[3]

According to Sylla credit rating agencies that we know today can be seen as a fusion of three functions performed by three institutions that preceded credit rating agencies in the years

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[1] R. Sylla, A historical primer on the business of credit rating, in R.M. Levich, G. Majnoni, C.M. Reinhart, Introduction: Ratings, Rating Agencies and the global financial sytem: summary and political implications, Kluwer Academic Publishers: 2002, p. 2.
[2] F. Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, Legal Studies Research Paper Series No. 07-46, May 2006, p. 63.
[3] R. Garcia Alcubilla, J. Ruiz del Pozo, *Credit rating agencies on the watchlist, analysis of European regulation*, Oxford University Press, 2012, p. 1.

before 1909.[4] These three institutions are the credit reporting agencies, the financial press and investment bankers. In the view of this author these institutions made it possible that the corporate bond market developed perfectly well without the presence of credit rating agencies.
In the years before 1909, not credit rating agencies, but rather credit reporting agencies in the United States gathered information through their own network and sold this commercial information about American businesses and their creditworthiness to subscribers. These parties filled in, or at least reduced, the information gap that existed between investors and companies in the financial market, which was caused and broadened by the expansion of the scale and scope of American businesses. Investors for example no longer personally knew the owners of the business they wanted to invest in. These companies could for instance be located far away. Credit reporting agencies provided investors in these situations with the information they needed.

The second alternative source of information that was widely used before 1909 and decreased the gap between American investors and businesses was the financial press. It was a product of the systematic gathering and publication of the financial and operating statistics of the American railroads from 1868 by firms like Poor's (of the later Standard & Poor's).[5] The financial press publicized details of corporate operations and therewith became a very important source of information for investors.

The last preceding institution, the investment bankers, also contributed to the development of the bond market before 1909 according to Sylla. By underwriting, purchasing and distributing financial instruments, investment bankers put their own reputation on the line with every deal and therefore demanded security in the form of all relevant information from issuers, or for example by a seat in the board of a company.[6] These bankers had access to inside and privileged information which later on in time created resentment from investors. They also wanted access to this specific information. In the 1930's the first mandatory disclosure laws would occur so all investors could have access to the same information. These three institutions all performed tasks or activities that today can be seen being performed by credit rating agencies.

After the crisis on the stock market of 1929 the business of rating agencies was in decline, and it remained that way for a long time.[7] What made the credit rating industry grow so rapidly in the United States was, among things, the adaptation of credit ratings for regulatory purposes after 1930. After the Great Depression regulators in the United States were in need of a credible point of reference, which was found in credit ratings. During the following years more and more laws that incorporated ratings were enacted. It took until the 1970's for the business to revive again. In these years the Securities and Exchange Commission (SEC) decided that it would begin to rely on a group of rating agencies in making its regulatory

[4] Sylla 2002, p. 19.
[5] Sylla 2002, p. 9.
[6] Sylla 2002, p. 9.
[7] Partnoy 2006, p. 63.

determinations. This is called the broker-dealer net capital rule or the NRSRO concept which will be explained hereafter. Besides the SEC later on also other administrative agencies established rules that depended on or required these NRSRO ratings, and after these developments things went quick.[8] The business continued to grow enormously during the 1980's and 90's. But an important part had changed. The rating agencies changed their business models from a subscriber pays-model to an issuer-pays model, this will be further explained under 2.1.4. Because of the new regulations that made ratings more important, the invention of a copy machine by which subscribers could more easily share rating information without paying and the fact that investors more often needed ratings for their whole portfolio, made rating agencies switch to an issuer-pays model.[9] As will be explained in a later stage, this new model would bring more conflicts of interest than the previous model.

1.2 GENERAL DESCRIPTION ON RATINGS AND RATING AGENCIES

There are several descriptions of credit rating agencies available. A credit rating agency is for example defined by the European legislator in article 3.1.(b) of Regulation 1060/2009 as:

> *‚a legal person whose occupation includes the issuing of credit ratings on a professional basis'.*[10]

A relative broad and general definition of a credit rating agency. With the Credit Rating Agency Reform Act of 2006, the U.S. legislator has created a somewhat different definition. A credit rating agency described according to American law is:

> *'any person - ''(A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; ''(B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and ''(C) receiving fees from either issuers, investors, or other market participants, or a combination thereof'.*[11]

This definition is far narrower and more precise. It contains certain eligibility requirements that cannot be found in the European definition. It is broader in the sense however that it in theory could also cover any natural person where the European definition only covers a legal person.[12] This if of course not what is meant.

The International Organization of Securities Commissions (IOSCO) finally describes a credit rating agency as:

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[8]Partnoy 2006, p. 64.
[9]Garcia Alcubilla, Ruiz del Pozo 2012, p. 4 and 5.
[10] Regulation (EC) No. 1060/2009 of the European Parliament and of the council of 16 September 2009, L302/9.
[11] Credit Rating Agency Reform Act of 2006, 15 USCS §78c.
[12] Committee of European Securities Regulators, *Technical advice to the*
European Commission on the equivalence between the US regulatory and supervisory
framework and the EU regulatory regime for credit rating agencies, CESR/10-332, 21-05- 2010, p. 56 and 57.

> *'those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities.'*

This definition comes relatively close to, and can be compared with the European definition. On the other hand a credit rating is defined by both the IOSCO and the European Committee of European Securities Regulators (CESR), now the European Securities and Markets Authority (ESMA), as:

> *'an opinion regarding the creditworthiness of an entity, a credit commitment, a debt of debt-like security or an issuer of such obligations, expressed using an established and defined ranking system. Credit ratings are not recommendations to purchase or sell any security'.*[13]

In its turn, the Credit Rating Agency Reform Act defines a „credit rating' as:

> *'an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments'.*[14]

Although the definitions are not completely equal they do refer to the same activities performed by the same companies. The fact that most of the rating agencies look alike is not new, but to which extent can they be treated as other financial actors such as banks and accountancy firms? Partnoy agrees with Coffee and others that credit rating agencies belong within the classification of financial market „gatekeepers'.[15] Gatekeepers can be described as

> *„reputational intermediaries who provide verification and certification services to investors'*.[16]

Partnoy however does state that credit rating agencies differ from other gatekeepers for the following reasons. Rating agencies are more profitable than other gatekeepers, they face different and potentially more serious conflicts of interests and they are like no other active in structured finance activities.[17] The reason why credit rating agencies are different from other gatekeepers when it comes to conflicts of interests is caused by the fact that rating agencies are directly paid by the issuers that they rate, but also because the majority of revenues of credit rating agencies are derived from the fees paid by issuers. Combined with the ancillary services provided by rating agencies that cannot be developed by other gatekeepers, at least in a way that rating agencies do, makes that rating agencies can be labeled as different at least with regard to conflicts of interest. The arguments that Partnoy uses underline perhaps even more that credit rating agencies should be seen as gatekeepers and should be treated that way as well. Rating agencies however prefer not to be seen as gatekeepers but more as publishing

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[13] Code of Conduct Fundamentals for Credit Rating Agencies, OICV – IOSCO, December 2004, p. 3.
[14] Credit Rating Agency Reform Act, section 3.
[15] Partnoy 2006, p. 59.
[16] J.C. Coffee, *What Caused Enron?: A Capsule Social and Economic History of the 1990's,* Columbia Law and Economics Working Paper No. 214, January 2003, p. 13.
[17] Partnoy 2006, p. 62.

companies. This has of course something to do with the liability discussion, where rating agencies at the moment are not subject to.[18] Besides that they do not want to be subject to more and stricter legislation in the future.

1.3 RATING TYPES

Credit rating agencies are privately owned companies that assign a credit rating or rating services to debt issuers such as; companies, financial institutions, insurance (related) companies, sovereign states, sovereign-supported entities and supranational issuers. Not only these aforementioned parties can be rated themselves, also their debt instruments/securities such as loans, bonds, convertible bonds and structured finance securities can be assessed and rated.[19] Credit rating agencies can operate on a regional, national or even international level. Ratings can furthermore be classified in types. The European Commission describes four types of ratings in their recently published technical standards namely: corporate ratings, structured finance ratings, sovereign and public finance ratings and covered bond ratings.[20] Corporate rating can be divided in i) financial institutions including credit institutions and investment firms, ii) insurance undertakings and iii) corporate issuers that are not considered as a financial institution or an insurance undertaking.[21] When looked at the rating of structured finance products it is possible to further differentiate between ratings of asset-backed securities, residential mortgage-backed securities, commercial mortgage-backed securities, collateralized debt obligations, asset-backed commercial papers and other structured finance instruments.[22]

A credit rating reflects a rating agency's opinion of, or perspective on the creditworthiness of a particular company, a financial instrument or obligation (as of a specific date).[23] It can be said that rating agencies perform activities in three different groups; namely the public sector, with regard to companies and structured finance instruments. Rating activities are however not the only activities performed by these agencies. They also perform ancillary activities and services like the issuing of short-term credit opinions, industry-specific ratings and analysis[24], consultancy or advisory services (proposals or recommendations regarding the design of a structured finance instrument)[25] and the issuing of public statements.

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[18] Partnoy 2006, p. 83.
[19] D. Stowell, An introduction to investment banks, hedge funds, and private equity: the new paradigm, Burlington, MA: Academic Press/Elsevier: 2010, p. 125.
[20] Commission Delegated Regulation (EU) No 446/2012 of 21 March 2012, L 140/3, Article 4.
[21] Commission Delegated Regulation (EU) No 449/2012 of 21 March 2012, L 140/34, Article 5.
[22] Commission Delegated Regulation (EU) No 446/2012, Article 4.
[23] U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market, January 2003, p. 5.
[24] B. Becker, T. Milbourn, *How did increased competition affect credit ratings?*, Journal of Financial Economics, 101 (2011) p. 500.
[25] Regulation (EC) No 1060/2009, under (22).

1.4 RATING PROCESS

With regard to rating activities two types of ratings can be differentiated; namely solicited and unsolicited ratings. Solicited ratings are ratings that are based on a request by a party that is participating in the rating process. This can be an issuing bank or a company, but also a country or a specific city or municipality. Solicited ratings are the most common rating type and are the result of a request by an issuer who pays a fee for the rating process. Unsolicited ratings are all other ratings besides solicited ratings, and cover each rating that is not initiated at a request of the issuer.[26] It for example can be a rating on demand of an investor. Unsolicited ratings can also occur when a rating agency receives the request from a company which can be considered „widely-held' to withdraw itself from a rating. In that case a rating agency often reserves itself the right to assign a rating and continue to inform investors.[27] Both solicited and un-solicited ratings can cause conflicts of interest. Chapter 2 will further address these problems.

Credit rating agencies all use different quantitative and qualitative models and methodologies to determine credit ratings. They do however in general follow the same steps. According to the Technical Committee of IOSCO, a general rating process has four main steps. Step one is a preparatory phase during which an analyst is appointed to gather information about the issuer, the characteristics of the security or obligation to be rated. If an entity is being rated itself, this person will search for information about the entity; During step two, which can be labeled as an assessment phase, the analyst applies the models and methodologies to the information to develop a recommendation for a rating committee; Step three is the decision phase, during which a rating committee will consider the analyst's information and recommendation. If sufficient members agree, the committee settles on a final credit rating that will be published by the credit rating agency; Step four is the dissemination phase. At this stage the credit rating will be publicly announced, or when it is not publicly available, privately disseminated by the credit rating agency.[28] It is possible that the issuer disagrees with the proposed rating. In that case an issuer can ask if the rating committee would reconsider its decision. Credit rating agencies are often reluctant to reconsider a decision unless there is new material information available or when there are signs that the credit rating agency information or judgment is incorrect. It is conceivable that they do not want to discuss their estimation and research. It might harm their reputation.

A credit rating agency in general will continue to monitor the issuer and/or its securities on an ongoing, but often less intensive, level after this last fifth step. [29]

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[26] H.A. de Savornin Lohman, M. G. van 't Westeinde, *Control and liability of credit rating agencies under Netherlands law*, Tijdschrift voor Financieel Recht, 2006-9, p. 218-219.

[27] D. Stowell 2010, p. 126.

[28] Technical Committee of the International Organization of Securities Commissions (IOSCO), *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*, May 2012, p. 6.

[29] The Technical Committee of the International Organization of Securities Commissions (IOSCO), *Report on the activities of credit rating agencies*, September 2003, p. 6.

There are several aspects that influence the rating of a debt instrument. First of all, the quality of assets, besides that the issuers existing liabilities, its borrowing and repayment history and finally the overall business performance can have influence on the rating of a debt instrument.[30]
The rating process furthermore involves an analysis of the business risk and the financial risk. The business risk involves the competitive position within the industry, the strategy and the sector risk. The financial risk can include the cash flow, financial flexibility and policy, profitability, capital structure, liquidity and debt management.[31] Informal non-public information, such as internal management reports, strategic orientations and forecasts, can also part of the rating formation. This information becomes available when a rating agency and an issuer discuss matters concerning the subject that needs to be rated. This information is supplemented with information that is generated by the credit rating agencies and public information. With unsolicited ratings the rating agency does not receive non-public information, most of the ratings are therefore based on information that is publicly available.[32] It can be questioned whether the use of non-public information in general should be tolerated. On one hand it is useful that issuers can provide information, this can supplement and therewith improve the quality and precision of the rating analysis. A high quality rating comes also for the benefit of other users of the ratings. It is for outsiders not possible to find out whether the information that is used is reliable information, agency analysis are also secret and may also contain wrong assumptions or risk analysis. On the other hand is it not possible, for at least European regulators, to check this non-public information, in contrast to the rating analysis and methodologies that are used by rating agencies that can be reviewed by financial regulators in the United States and Europe. The use of non-public information generated through informal meetings is therefore not desirable.

A review of all sorts of financial and other information is translated by the rating agency into a rating. This rating indicates the issuer’s ability to repay or meet its obligations (the obligation to pay back the principal and interest). It in other words, the rating reflects the issuer’s (relative) credit worthiness, the likelihood that the repayments associated with holding a particular debt security will be made on time, in accordance with the terms upon which was agreed by parties and the likelihood that the issue may default.[33] Credit rating agencies emphasize that ratings only represent the opinion of a rating agency with reference to a certain financial product, company or sovereign state at a certain point in time. They do not indicate an investment merit or an absolute measure of risk. According to rating agencies they are relative and therefore should be considered with reference to other ratings. Fact is that the public often grants a certain absolute value to the ratings.[34] The question is how long rating agencies can maintain this argument when ratings have gotten more and more impact on the financial markets during the last couple of years. For just an

[30] B. Becker, T. Milbourn 2011, p. 499.
[31] Stowell 2010, p. 125.
[32] Garcia Alcubilla, Ruiz del Pozo 2012, p. 19.
[33] H. McVea, Credit rating agencies, the subprime mortgage debacle and global governance: the EU strikes back, ICLQ vol. 59, July 2010, p. 705.
[34] Garcia Alcubilla, Ruiz del Pozo 2012, p. 59.

opinion of a publishing company, as they like to label themselves, the consequences are incomparably high.

Rating agencies generally give their long-term ratings a code in variations of an alphabetical combination of lower and upper letters that go from AAA to D (these are called categories). Sometimes modifiers in the form of number or a plus/minus are added to these letters (these are called modifiers) in order to distinguish further within certain ranking.[35] Each rating agency uses its own combination, but they look very similar.[36] The combination of a category and a modifier form a „notch' in the rating scale, like an A+.[37]

Standards & Poors[38]	**Moody's**[39]	**Fitch**[40]
	Investment Grade	
AAA	Aaa	AAA
AA	Aa	AA
A	A	A
BBB	Baa	BBB
BBB-		
	Speculative Grade	
BB+	Ba	BB
B	B	B
CCC	Caa	CCC
CC	Ca	CC
C	C	C
C1		RD
D		D

What can be noticed in the table above is that there is a distinction between investment grade and speculative grade. Investment grade indicates that is concerns issuers or issues with a relatively high level of creditworthiness and credit quality. The speculative grade on the other hand refers to debt securities, financial instruments and issuers that are able to meet their obligations at the moment but face significant uncertainties which can affect the credit risk.[41]

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[35] Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 2003, p. 25.
[36] P.R. Wood, *Law and Practice of International Finance*, London: Sweet & Maxwell, 2008, p. 333.
[37] Garcia Alcubilla, Ruiz del Pozo 2012, p. 59.
[38] Standard & Poor's, *Guide to Credit Rating Essentials, What are credit ratings and how do they work?*, Lightbulb Press, p. 12.
[39] Moody's Investor Service, *Moody's Rating Symbols and Definitions*, June 2009, p. 9.
[40] Fitch Ratings, *Definitions of Ratings and Other Forms of Opinion*, April 2012, p. 12 and 13.
[41] Standard & Poor's 2011, p. 13.

1.5 USERS

As said before there are various possible issuers, not only companies but also special purpose vehicles and banks (private entities), state and city governments, nonprofit organizations, agencies and other public institutions can be debt issuers or issuers of financial instruments. Investors like credit institutions, investment firms, (re)insurance, assurance companies, undertakings for collective investment in transferable securities (UCITS) and institutions for occupational retirement provisions, also rely on ratings when they make their investment and regulatory decisions.[42] Other users are financial analysts and financial intermediaries.[43]

When an issuer of let's say a public market bonds wants to attract investors, it will most of the time need a rating from one or more rating agencies.[44] By obtaining the best rating possible, its interest costs will be as low as possible, and the issuer will get effective access to the capital market. A rating has influence on the interest rate that will be applied to the security that is rated.[45] An investor will demand a higher interest rate when the investment is more risky. Becker and Milbourn mention three reasons why an issuer would seek a rating. Firstly, it may improve the marketability or the pricing of their financial instrument, it secondly can increase the issuer's trustworthiness and it finally may increase the selling process to investors with preferences over ratings. Besides these reasons it is also possible that a rating is obliged by regulation, which can be the case with institutional investors like banks, insurance companies and pension funds, when they need to make their investment decisions.[46] Credit ratings are mostly used in legislation to determine capital requirements of institutions such as banks and investment firms. Credit ratings subsequently can provide an evaluation of the credit risk associated with assets purchased as part of a securitization or a covered bond offering, they are furthermore used to determine disclosure requirements and the prospectus eligibility. Apart from that ratings are also used to identify or classify assets. They are a way to find out whether a specific investment is an eligible investments or if it contains a permissible asset concentrations.[47] Garcia Alcubilla and Ruiz del Pozo came up with an example in current legislation that mandates the use of ratings in this last category.[48] In the Commission Directive 2007/16/EC of 19 March 2007 articles 6 and 10 both contain references to credit ratings.[49]

1.6 IMPORTANCE FOR THE FINANCIAL SYSTEM

Credit rating agencies are independent providers of credit opinions in the financial market. As said, their main business is to analyze business or governmental information and to

[42] Regulation (EC) No 1060/2009, under (1).
[43] Garcia Alcubilla, Ruiz del Pozo 2012, p. 12.
[44] Stowell 2010, p. 126.
[45] Stowell 2010, p. 125.
[46] Becker, Milbourn 2011, p. 499.
[47] Garcia Alcubilla, Ruiz del Pozo 2012, p. 16.
[48] Garcia Alcubilla, Ruiz del Pozo 2012, p. 17.
[49] Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions, OJ L 79/11.

subsequently issue an opinion with regard to the creditworthiness of a company, a government or a financial debt instrument. These ratings are closely followed by various parties such as investors, governments, borrowers and issuers.

The grow in importance and influence of credit ratings can be explained by;

- the increase in the number, and anonymity of participants in the financial markets;
- the shift of supply of credit from banks to capital markets;
- the creation of new and often complex financial products;[50]
- the complexity and diversity of investment strategies of these participants;
- increased reliance of sovereigns on bond financing;[51] and,
- finally, the fact that actors in the market are offered a time-saving and comparative tool to evaluate the growing number of debt issues.[52]

Credit ratings are firstly important specifically for issuers because they want to know what kind of rating their financial product or company is given. This is important for them because a rating most certainly will influence the costs of the capital (as in the interest rates they will have to pay for the capital raised) they want to raise. A good rating will improve the marketability of their product but it can also satisfy their counterparties when these parties want to improve management responsibility.[53]

Secondly, investors such as insurance companies, pension funds but also mutual funds, are substantial users of credit ratings. They want to find out what kind of risk comes with their investment, and if they want to take that risk. Besides that they can also use these ratings next to their own internal credit assessments and investment analyses in order to make proper and well informed investment decisions.

Thirdly, also a credit institution, another kind of investor, can be interested in a rating because they are entitled to use ratings for the calculation of their capital requirements as a result of references to credit ratings in financial regulation.[54] Finally, ratings can be attractive for this specific group because they want to check whether they comply with by-law restrictions or investment policies that require a minimum rating.[55] Broker-dealers also make use of credit ratings, they are often labeled as sell-side firms. They rely on ratings themselves when they act as issuers of debt, but also use and rely on ratings when they assist issuers in finding an appropriate rating agency. The importance of credit ratings to investors has impact on the issuer's access to, and the cost of capital. It has influence on the structures of financial

[50] U.S. Securities and Exchange Commission 2003, p. 5.
[51] P. Maris, *The regulation of credit rating agencies in the US and Europe: historical analysis and thoughts on the road ahead*, 2009, p. 3 and 4.
[52] U.S. Securities and Exchange Commission 2012, p. 16.
[53] Securities and Exchange Commission 2003, p. 27.
[54] European Commission, Commission Staff Working Paper, *Impact Assessment*, SEC (2011) 1354, p. 6 and 7.
[55] Securities and Exchange Commission 2003, p. 28.

transactions in the market and on the ability to make certain investments.[56] Credit ratings reduce uncertainty for these parties.

Alongside with the importance for these actors, ratings are also important for regulatory use and are often used in private contracts. In case of private contracts ratings can be included in the form of „triggers'. Triggers are contractual provisions that terminate credit availability or accelerate credit obligations in the event a specified rating occurs.

The European Commission recently described two general reasons why credit ratings are of great importance at least for the European market.[57] One of them is the regulatory tool, the other one is reduction of the information asymmetry. According to the Bank of England there are at last three functions that make the role of rating agencies important. Among these functions is also the fact that rating agencies provide for the mitigation of the information asymmetry, but apart from that also offer a tool for solving principal-agent and collective action problems.[58]

1.7 REGULATORY TOOL

In recent legislation credit rating agencies have been assigned a role which in literature is classified as "the certification function". This term is reflecting the fact that ratings are increasingly embedded in regulatory capital requirements.[59] They are used as a tool for measuring and limiting risk by institutions that face regulatory rules based on credit ratings such as commercial banks, insurance companies and pension funds.[60] A good example of the use of credit ratings for a regulatory purpose is the use of ratings by the Basel Committee on Banking Supervision who permits banks to use ratings from certain accredited credit rating agencies to determine minimum credit risk capital requirements under the Basel II Accord.[61]

The Capital Requirements Directive is the European implementation of the Basel II provisions in legislation and contains of a set of standards for establishing minimum capital requirements for banking organizations.[62] In Basel II references to credit ratings can be mainly found in the first pillar but also under the third. External credit ratings are mostly used by banking organizations to calculate the risk weight of their exposures to the corporate, sovereign and banking classes under the standardized approach.[63] Other references can be found in the credit ratings mitigation rules and market risk and operational risk rules (first pillar), and within pillar three under market discipline.[64]

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[56] Securities and Exchange Commission 2003, p. 4.
[57] W. Klintz, *Draft Report on credit rating agencies: future perspectives*, Committee on Economic and Monetary Affairs, 24 November 2010.
[58] Bank of England, *Financial Stability Report*, October 2007, No. 22, p. 56.
[59] Klintz 2010, p. 3 under C.
[60] Becker, Milbourn 2011 p. 493.
[61] McVea 2010, p. 707.
[62] Garcia Alcubilla, Ruiz del Pozo 2012, p. 85.
[63] Garcia Alcubilla, Ruiz del Pozo 2012, p. 86.
[64] Garcia Alcubilla, Ruiz del Pozo 2012, p. 86.

The Basel Committee on Banking Supervision mentioned in their report of June 2011(revised version) concerning Basel III a number of measures to mitigate the reliance on external ratings of the Basel II framework.[65] These measures include for instance:

„requirements for banks to perform their own internal assessments of externally rated securitization exposures, the elimination of certain "cliff effects" associated with credit risk mitigation practices, and the incorporation of key elements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies into the Committee's eligibility criteria for the use of external ratings in the capital framework.' It can therefore be expected that the reliance on credit rating will be reduced by the Basel III requirements.

1.8 INFORMATION FUNCTION

Apart from the regulatory function, ratings also have an important information function. In order to make informed investment and financing decisions, credit ratings are an important part of information that is often used by investors, borrowers, issuers and governments. Credit ratings therefore play an important role in global securities and banking markets. These entities may use credit ratings as the reference for the calculation of their capital requirements, for solvency purposes or for calculating risks that come with their investment activity. Credit ratings have therefore a significant impact on the operation of the (financial) markets and on the trust and confidence of investors and consumers.[66] By collecting useful information for investors about the credit worthiness and financial instruments of issuers in a global environment, credit rating agencies reduce the fundamental information asymmetry and make the financial market more open and accessible for investors. They also reduce information costs, therewith providing liquidity to markets and helping find prices.[67] As a result issuers can get access to global and domestic markets and can reach more investors than before. Ratings allow (uninformed) investors to quickly assess the broad risk properties that come with the numerous financial instruments and securities, using a single standardized well-known scale.[68].

Tool to prevent principal-agent problems

The relation between an investor and an issuer can be described as a principal-agent relationship. This is because the issuer (the agent) is most of the time in a position that it has more information about the financial instruments or its own creditability superior to the investor (the principal). Ratings can solve some of the principal-agent problems.[69] By establishing a minimum rating for certain assets investors can cab agents in the amount of risk they take by restricting them to invest in markets or products that have a certain rating.

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[65] Bank for International Settlements, *Basel III A global regulatory framework for more resilient banks and banking systems*, December 2010, p. 4 under 15.
[66] Regulation (EC) No 1060/2009, under (1).
[67] Klintz 2010, p. 3 under B.
[68] Becker, Milbourn 2011, p. 493.
[69] Garcia Alcubilla, Ruiz del Pozo 2012, p. 6.

Tool in collective actions
Rating finally can furthermore help creditors when it comes to collective action problems. For most of the investors it is very difficult to monitor companies, and it often takes for these stakeholders to find out when things go wrong. A downgrading by a rating agency do help these parties. If a company continues its business even when the financial situation should force them to stop. Stakeholders such as investors can be helped by the downgrade in a collective action when it comes down to prove that the firm reduced recovery values for these creditors.[70]

1.9 CONCLUSION

Credit rating agencies are private independent companies that provide credit opinions and other services to the financial market. Apart from that they can be labeled as gatekeepers. They are not yet treated as gatekeepers but when you look at the arguments of Partnoy they probably should.
Although ratings and credit rating agencies are defined differently when we compare the United States, Europe and the definition of the international organization, IOSCO, they do refer to the same activities performed by the same companies. Their main business of rating agencies is to analyze business or governmental information to subsequently issue an opinion with regard to the creditworthiness of a company, a government or a financial debt instrument. Besides these rating activities, agencies also perform ancillary activities and services such as consultancy and advisory services and the issuing of public statements. These private companies therewith offer various financial tools for various actors on the financial market. Rating agencies have an important role because of its capabilities to provide a tool in preventing principal-agent problems and collective actions, but it apart from that also reduces an information asymmetry and provides for a starting point for the financial market and regulators to rely on.

It can be concluded that the importance and influence of credit ratings has increased during the years, as a result of the increasing number of (anonymous) participants that have entered the financial markets combined with increasing use of more and more complex and diverse offer of financial products and a bigger general reliance on credit ratings.[71] The answer to the question „how important are credit rating agencies for our financial system?' is therefore easy to answer. Very important. Many market participants today rely on ratings provided by rating agencies. Not only investors but also issuers and regulators and even parties in private contracts.

[70] Garcia Alcubilla, Ruiz del Pozo 2012, p. 6.
[71] U.S. Securities and Exchange Commission 2003, p. 5.

2 CONTROL OVER RATING AGENCIES BY EUROPEAN AND AMERICAN LEGISLATORS

Credit rating agencies have remained unregulated for a long time. It can therefore be said that rating agencies during the last years moved from an unregulated surrounding of self-regulation to a far stricter regime with extensive legislation and oversight by public authorities.72 Although much has been said and written during the last couple of years about rating agencies it is perhaps good to retrieve shortly why legislators try to gain more control over credit rating agencies.

The current Euro crisis but also the financial crisis of 2007 and even earlier the Asian crisis in 1997 have all contributed to the current discussion about the role and capabilities of credit rating agencies in the financial market. During these different periods of crisis and after the collapses of several bigger companies in the United States and Europe (like Enron, Parmalat and Worldcom) which were not foreseen by rating agencies, waves of criticism were generated by the public and legislators worldwide. Not so strange since rating agencies were given powerful discretion and many actors in the market relied on their information.[73]

The European Commission divided the failures of credit rating agencies into four categories. The first category is contained the failure in integrity.[74] Concerns with regard to the use of certain business models, concerns about the impartiality of ratings and concerns with regard to the undue influence of issuers/originators established the general worries with regard to conflicts of interest and integrity. The second category contains failures with regard to reliability.[75] The lack and inappropriate performance of rating methodologies and assumptions, inconstancies found in older ratings of rating agencies and late downgrades and finally serious doubts on the capacity to timely and adequately rate structured products created worries with regard to the reliability of credit rating agencies. Third category contains the failures in transparency. Mostly the provision of insufficient information on credit model assumptions and the leak of available information to compare rating agency performance with other rating agencies were seen as problematic.[76] The lack of competition forms the last category.

Credit rating agencies have become an important part of the financial market as seen in Chapter 1. The use of ratings and the role they play in today's financial market is significant. The fact that regulators started to use ratings in regulation inserted rating agencies into the public domain.[77] Its importance together with its failures created the urge for legislators to take measures with regard to credit ratings agencies and their activities.

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72 Garcia Alcubilla, Ruiz del Pozo 2012, p. 260.
73 McVea 2010, p. 708.
74 Garcia Alcubilla, Ruiz del Pozo 2012, p. 28.
75 Garcia Alcubilla, Ruiz del Pozo 2012, p. 28 and 29.
76 Garcia Alcubilla, Ruiz del Pozo2012, p. 30.
77 P. Gavras, *Ratings Game*, Finance and Development, March 2012, p. 34.

2.1 CRITIQUE TOWARDS CREDIT RATING AGENCIES IN EUROPE

According to Möllers there are three core instruments of maintaining a functional capital market. You first need to avoid conflicts of interests. Secondly, you need to implement duties to disclose, and you will thirdly need adequate supervision. Absence or the non-functioning of these instruments are according to Möllers ingredients for a perfect storm.[78] But do the European and United States regulators feel the same about that? Are there only three main instruments or are there perhaps more? Do the European and United States regulators focus on the same issues or are there differences?

At the moment it is possible to describe six core issues when we look at criticism on credit rating agencies at a European level that dominate the discussion of whether or not more European legislation for these agencies is necessary. These six issues are as follows: (1) the dependency and overreliance on external credit ratings by regulators and market participants, (2) the lack of competition and choice in the market of credit rating activities, (3) the debate on liability of credit rating agencies and an insufficient right of redress for users of ratings, (4) the conflicts of interest that comes with performance of the different activities by credit rating agencies, the "issuer-pays" model, ownership structure and long tenure of the same credit rating agency, (5) effects of sovereign debt rating changes, and finally (6) insufficiently sound and transparent rating methodologies and processes. These issues, which can also be labeled as consequences, can cause global problems in the end such as: risks to market stability, low confidence in the financial markets, they can undermine investor confidence and the quality of ratings in general according to the Commission.[79]

2.1.1 Dependency and overreliance on external credit ratings

When actors in the financial market rely heavily on external credit ratings there is a big chance that this might lead to so called "herd behavior and cliff effects"[80], because these parties sometimes for various reasons cannot verify sudden changes in ratings. Cliff effects are sudden actions that are triggered by a rating downgrade under a specific threshold can lead to disproportionate cascading effects.[81] Possible causes for the fact that many actors in the financial market rely heavily on external credit ratings or factors that at least encourage the use of these ratings are: the requirements to use external credit ratings in legislation, the excessive use of eternal ratings for internal risk management, investment strategies directly linked to ratings and insufficient information on structured finance products.[82]

In his report for the Committee on Economic and Monetary Affairs, Klinz proposes certain solutions in order decrease the overreliance on external credit ratings. He adds that it is important in this matter to differentiate between the three different market sectors in which a credit rating agency can be active: companies/ corporate, public sector and the sector of

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[78] T.M.J. Möllers, Regulating Credit Rating agencies: the new US and EU law – important steps or much ado about nothing?, Capital Market Law Journal, Vol. 4, No. 4, p. 480-481.
[79] European Commission 2011, p. 3.
[80] European Commission 2011, p. 11.
[81] European Commission 2011, p. 2.
[82] European Commission 2011, p. 3.

financial instruments.[83] Klinz proposes that: small players on the rating market should be allowed to use external credit ratings but only if they can fully understand the risks involved and can conduct a proper due diligence. By increasing an investor's ability to conduct their own due diligence and risk assessment reliance can be reduced;
At the moment the European Central Bank (ECB) relies heavily on external ratings, this reliance should be revised;
Regulators and supervisors need to be able to assess the use of proprietary internal models to reduce the need for external ratings. Market participants need to be required to design their own evaluation models (depends on the ability of firms and the availability and transparency of the information used for external ratings particularly for structured finance instruments);[84]
And finally the disclosure of information to investors needs to be increased.[85]

2.1.2 Lack of competition and choice in the market for credit rating activities

At the moment there are 29 registered and certified credit rating agencies active within the European Union, and 10 Nationally Recognized Statistical Rating Organizations (NRSRO's) in the United States. In both Europe and the United States three players have a dominate position in the credit rating market. The largest and best known rating agencies of the moment in both the United States and Europe are Standards & Poor's, Moody's Investors Service and Fitch Ratings. These three leading agencies are responsible for 98% of all outstanding rating and for 90% of the total rating revenue.[86] It therefore can be said that there is not much competition in this market and the level of concentration is high. This high market concentration together with high barriers of entry into the market and lack of comparability of ratings can be designated as the reasons behind this issue. Examples of such barriers are the capital requirements that are demanded from these agencies and the fact that they need to be recognized as an External Credit Assessment Institution in order for their ratings to be used for regulatory purposes. New companies in this market furthermore need to battle the reputational barrier created by the biggest rating agencies and have a disadvantage when it comes to the high profit margins and the little transparency with regard to pricing by existing rating agencies.
Klinz also names four solutions in order to reduce these problems. Competition and more choice in the market for credit rating agencies may return when first of all, a fully independent non-public European Credit Rating Foundation (ECRaF) or credit rating agency is established. Furthermore, fostering the establishment of a new network of European credit rating agencies, and the possibility to make two ratings from two different agencies obligatory for structured finance products in order to reduce the dominance of the three biggest credit rating agencies, could also help.[87]

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[83] Klinz 2010, p. 8.
[84] Autorité des marches financiers (AMF), *report on credit rating agencies 2010*, 19 august 2011, p. 6.
[85] Klinz 2010, p. 9 and 10.
[86] A. Darbellay, F. Partnoy, Credit Rating Agencies and Regulatory Reform, Legal Studies Research Paper Series, no. 12-083, April 2012, p. 2.
[87] Klinz 2010, p. 9 and 10.

Other possible options are: the development of ratings issued by for example the European Central bank and National Central Banks, stimulating new entrants and a public/private structure or a European network of small and medium-sized credit rating agencies. These last options may however raise questions with reference to the public involvement that might not be the best solution in this matter.[88]

2.1.3 No liability for credit rating agencies

In most cases, the CRAs communicate with the issuer's management and thus also base their ratings on non-public information.[32] Credit rating agencies however might not verify the accuracy of accounting, financial or other information and are not liable under securities laws for failing to do so. In other words failing to verify the truthfulness and non misleading character of such information cannot be sanctioned yet.[89] At least not in every member state, and not based on more or less the same grounds. At the moment, of all member states only France has a specific regime of tort-based liability for rating agencies that will be registered under the regulation and whose ratings will be used in the European Union for regulatory purposes.[90] The differences between member states with regard to civil liabilities regimes applicable to credit rating agencies leads to different levels of protection for investors and could even cause forum shopping.[91]

The threat of a loss of reputation with regard to verification of information is hardly there for rating agencies because there is not enough competition in the market.

A solution can be that credit rating agencies can be held accountable and liable for their ratings in the future. But for now the lack of civil liability regimes in some member states and the risk of regulatory arbitrage prevent improvement at this point.[92] Especially for investors, who often do not have a contractual relationship with a rating agency, is it difficult to hold agencies liable and claim damages when infringements or gross negligence take place.[93]

2.1.4 Conflict of interests

The conflict of interest issue can be created by the ownership structure, a possible "lock-in effect" and the remuneration model that is used by credit rating agencies. First of all what can be said about the ownership structures with regard to the conflict of interest is the following. The independence and trustworthiness of ratings can come into question when for example an agency rates a firm or a financial instrument that is issued by a firm that is owned by one of its shareholders. It can be tempting for a rating agency to be more positive than would be justified in that case.

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[88] Autorité des marches financiers 2011, p. 6.
[89] A. Champsaur, The regulation of credit rating agencies in the U.S. and the EU.: recent initiatives and proposals, Harvard Law School, May 2005.
[90] Act No 210-1249 of 22 October 2010.
[91] European Commission 2011, p. 19.
[92] European Commission 2011, p. 3.
[93] European Commission 2011, p. 18.

The fact that some issuers stick with a specific credit rating agency for a long time because they are afraid of the effect that might occur when they switch to another rating agency is called the "lock-in effect". Investors might get suspicious when an issuers changes agencies and this could have an effect on the trade in that financial instrument or on the share price of an issuer. When an issuer changes rating agencies every once in a while, the danger of a conflict of interest can be reduced because a third party will look at the facts again and will judge whether the rating is correct. A lock-in effect therefore has a bad influence on the cutback of conflicts of interests.

Then there is the remuneration model of credit rating agencies. There are several remuneration models with regard to credit rating agencies. All of them carry their own potential conflicts of interests. The one that is by far the most dominant is the "issuer-pays" model. According to this model, issuers solicit and pay for the ratings of their own debt instruments.[94] Inherent to this model is that credit rating agencies have a financial interest in generating (more) business from the issuers that seek the rating in the future, which could lead to assigning higher ratings than would be justified. Other models are: the "subscriber-pays" model were rating agencies make money by selling ratings to investors who pay a subscription fee to get access ratings, and the "public utility/government" model, where the agencies is in the hands of the government, a model that is not used in practice at the moment. Where credit rating agencies during their first years mainly realized revenue from selling information to investors and other users (via the investor/subscriber-pays model), it later on (from the 1970's onwards) switched to revenues from issuers of securities and financial products as their main source of income (the issuer-pays model).[95] Potential conflicts of interest also come with the subscriber-pays model. It is possible that a large investor for instance may try to influence a rating agency to provide lower initial ratings (which normally tend to provide higher yields), while institutions that can only invest in highly rated instruments, because of regulatory or contractual requirements, might pressure an agency to assign an investment-grade rating on a specific security.[96] Besides that it is questionable if this model would work nowadays. There is a free-rider possibility and there is a high doubt that revenues from this model will be high enough to fund all the research that needs to be done by rating agencies in order to get a proper risk analysis and a proper rating.

Klinz proposes several solutions for the conflict of interests' issue. In his opinion the conflicts of interests that come with the issuer-pays model can be battled by prohibiting credit rating agencies to provide advisory services besides rating activities. Furthermore it might help to make the board of directors more independent to help address the disadvantages caused by conflicts of interests.[97]

The development of a new remuneration model besides the issuer-pays and subscriber-pays model could also be a viable solution when trying to reduce the conflicts of interests. There

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[94] European Commission 2011, p. 144.
[95] Sylla 2002, p. 24.
[96] European Commission 2011, p. 145.
[97] Klinz 2010, p. 11.

are more models like the "Payment-upon-Results/Performance-based" model, the "Trading-Venues-Pay" model and the government as "Hiring Agent" model that can replace the current models but it is also possible that these models will bring conflicts of interest of their own.[98]

2.1.5 Sovereign debt

Sovereign credit ratings can be defined as:

> *'a condensed assessment by credit rating agencies of a government's ability and willingness to repay its public debt both in principal and in interests on time'.*[99]

Sovereign debt rating, as one of the credit rating agencies' activities, has increased enormously during the last couple of years. This is caused by the fact that more and more governments and financial institutions borrow on international bond markets. These sovereign ratings have an important signaling effect to investors. Because of heavy reliance on these ratings' changes like downgrades can have huge consequences.[100] There are three reasons why sovereign ratings are however so important.

First of all, sovereign ratings are a key determinant of a country's borrowing costs in international capital markets. The ratings are therefore essential for the countries' access to the capital market. Besides that, sovereign ratings do not only affect financing costs for a country but also affect and contain companies and credit institutions and provide them with access to the international capital market within that country.

Finally, sovereign ratings also expand the pool of potential buyers of a country's bond issuances to institutional investors. These ratings are important indicators for investors that have a lower bound/restriction for risk.[101]
Because the information on which the ratings are based is publicly available it might be strange that sovereign ratings are so popular. For certain parties on the financial markets such as the „sophisticated' actors there is no need to exclusively rely on these ratings, they could do the risk assessment themselves.[102]
The insufficient objectivity and completeness of the sovereign rating process, the lack of transparency, the level of qualification and expertise of the staff and inappropriate timing of rating publications are the causes for the fact that sovereign debt rating has become an issue on the list of the European legislator.

Increasing transparency of the rating methodologies and research reports among others measures, can help to reduce these problems.[103] The question is whether it is possible to do something with regard to the publication of sovereign ratings. Various European member states have experienced a sudden downgrade by rating agencies in the past years. Because

[98] Autorité des marches financiers 2011, p. 7.
[99] European Commission 2011, p. 135.
[100] European Commission 2011, p. 135/136.
[101] European Commission 2011, p. 136.
[102] Klinz 2010, p. 10/11.
[103] Autorité des marches financiers 2011, p. 6.

governments communicate relevant information throughout the whole year it is hard to predict changes in rating up front, if compared to the corporate sector. Seen the importance of sovereign ratings and the impact of these downgrades on various layers and actors within the financial market, more transparency and consistency from the side of rating agencies are desirable.

2.1.6 Insufficiently sound and transparent rating methodologies and processes.

The insufficient communication and leak of transparency of ratings and their underlying methodologies, along with inappropriate timing of the publication of ratings cause problems with regard to the rating activities. These problems form the last issue that is addressed by the European Commission. A lack of transparency with regard to rating methodologies can contribute to uncertainty in the market and in the end harm market stability. Investors are not always aware of underlying assumptions or (changes of) rating methodologies. Also the timing of publication of ratings could be improved. Issuers often do not have the time to analyze the rating properly before it is made public. Errors of rating agencies are therewith hard to notice and the potential damage can be extensive. The solutions to these issues are not hard to imagine. Increasing the disclosure of information to investors in order to enable them to fulfill due diligence and fiduciary duties would help to reduce these matters. When parties are enabled to make their own risk assessment the threat of disruption or uncertainty in the market can be reduced.[104]

2.3 SUB CONCLUSION

At the moment six core issues dominate the discussion on the European level of whether or not more European legislation for credit rating agencies is necessary according to the Commission. The reliance on external ratings needs to be reduced. More disclosure and transparency in the direction of investors and with regard to rating methodologies is desirable. Finally, more transparency and consistency in publication will also reduce the problems with regard to sovereign ratings.

By creating an independent European rating agency, stimulating other new entrants to the market along with proscribing the use of two ratings in certain matters should reduce the leak of competition in the rating market. The insufficient right of redress can be solved by new European legislation in a way that rating agencies can be held liable in each member state on the same grounds. Conflicts of interest can furthermore be battled by reduction of activities that credit rating agencies are allowed to perform or new business models. Because each model brings its own conflicts, is it doubtful that problems in spite of new models will totally disappear.

[104] Klinz 2010, p. 10.

2.4 CRITIQUE TOWARDS CREDIT RATING AGENCIES IN THE UNITED STATES

The Senate Committee on Governmental Affairs held a hearing in March 2002 with regard to the Enron debacle of the year before. In October 2002 a report was presented by this committee, the so-called „Staff Report'. In order to find an answer to the question how rating agencies could have had such a positive investment prospect on Enron just until a few days before the collapse of the undertaking, the committee found quite some interesting comments. It concluded that rating agencies among other things 1) represented a lack of diligence in their assessment of companies. They 2) failed to use their powers and access and 3) did not ask sufficient questions. Because there was 4) little or no formal regulation, 5) little or no oversight and 6) limited liability for rating agencies, there were no consequences for poor performances of these companies.[105]

Further investigation and examination of NRSRO's by the SEC in 2003 revealed more concerns with regard to credit rating agencies. The first one being that potential conflicts of interest could occur created by the fact that issuers would pay the credit rating agencies for their ratings.[106] Besides that the SEC was of the opinion that these conflicts of interests could turn out bigger when the marketing of ancillary services to issuers provided by credit rating agencies was also taken into account. In this case more transparency of the rating process and an increase in the availability of public information of ratings was necessary.

The second issue that was mentioned in the SEC investigation was the absence of competition in the market for rating activities, and therewith the possibility that rating agencies could pressure their issuers for ratings.

Worry with reference to the effectiveness and protectiveness of existing procedures of credit rating agencies that should protest confidential information formed a third issue marked by the SEC. Credit rating agencies are however of the opinion that the nature of and the analysis on the quality of the rating process depends on the quality of information provided to them. They normally do not see it as their task to check and control this information in debt according to the SEC.

The last issue mentioned by the SEC in their report of 2003 is the effectiveness to cooperate with the SEC's examinations, which means the retention and recordkeeping of documents plus the successful shielding with the First Amendment in order to prevent producing certain documents to the SEC.

That was 2003. The Dodd-Frank Act in the meantime mandated the SEC to develop legislation with regard to credit rating agencies. In a testimony concerning the oversight of the credit rating agencies post Dodd-Frank, John Ramsay (deputy director on the Division of Trading and Market at the SEC) explained in 2011 which topics have the priority of the SEC

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[105] Securities and Exchange Commission 2003, p. 18.
[106] Securities and Exchange Commission 2003, p. 23.

at the moment, which proposals recently have been adopted and which proposals are issued to the public with a request for comments with regard to credit rating agencies.[107] It can be said that three topics currently control the debate and reports with regard to rating agencies in the United States. These issues are addressed in the latest report of the SEC of March 2012 and are the competition, the transparency of ratings and the conflicts of interest.

2.4.1 Competition

The competition issue is a subject that the United States legislator has put on its agenda just like the European legislator. There is no doubt that the market for credit rating activities is highly concentrated even throughout much of its history. Competition is important because it can have many positive effects such as more choice for investors, higher rating quality and potential lower costs. The SEC, together with researchers such as Partnoy, is of the opinion that regulatory use of ratings (the NRSRO-concept) attributed to barriers of entry for other potential participants in this market, which let to further concentration.[108] The SEC mentions several factors that can influence or limit competition. Economies of scale, sunk costs, access to historical default distribution and the importance of a reputation are economic factors that can influence the choice of actors in the financial markets in favor of larger credit rating agencies in their opinion. Surely these bigger rating agencies are better able to allocate costs over a wider and larger range of ratings. They also have extensive resources and experience. Network externalities, which exist when the value of a product increases as more people use it, can also create an obstacle for new markets entrants according to the SEC. Besides these obstacles, private contractual agreements that reference the ratings, rating triggers and barriers for certain rating agencies to obtain information needed to assign a certain rating may also limit competition.[109]

During the last couple of years several provisions were established to increase competition. Examples of these provisions are for instance the registration process that is designed to make it easier for rating agencies to become an NRSRO, several disclosure requirements such as the disclosure of performance statistics and disclosure of procedures and methodologies, disclosure of (managing) conflicts and lastly the procedures for protecting material, non-public information. Recently extra requirements for NRSRO's were added by demanding them to publicly provide the ratings histories. With these rules the legislator tries to create greater comparability and accountability between NRSRO's and to create more competition among them.[110] Rule makers in the United States also tried to increase competition for structured finance rating by creating a mechanism for NRSRO's that were not hired to do the job to nonetheless monitor and determine ratings given by the selected rating agency. The selected NRSRO therewith had to provide other NRSRO's with its rating information.

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[107] U.S. Securities and Exchange Commission, *Testimony concerning oversight of the credit rating agencies post-Dodd-Frank*, July 27 2011.
[108] Securities and Exchange Commission 2003, p. 16 an 17.
[109] Securities and Exchange Commission 2003, p. 20 and 21.
[110] U.S. Securities and Exchange Commission 2012, p. 23.

NRSRO's furthermore need to disclose how they rely on information for a rating based on a due diligence.[111]

2.4.2 Transparency

The insufficient communication and leak of transparency of ratings and their underlying methodologies worried the European legislator. The U.S. legislator has put transparency also high on its watch list. Section 932 of the Dodd-Frank Act which is titled: „*Enhanced regulation, accountability, and transparency of NRSROs*,' contains various provisions to increase the transparency on ratings but also on rating methodologies. The SEC is with Congress of the opinion that the quality of rating can be improved by fostering transparency together with accountability and competition in the rating agency industry. Most of the new provisions demand more publication of all kinds of matters, the use of specific forms and the use of fixed procedures and methodologies. The danger that comes with all these measures is that rating agencies because of all these (disclosure) requirements are buried by legislation. This increase in regulatory measures could threat competition in the end because smaller rating agencies and newcomers will have a hard to getting by with all these requirements.

2.4.3 Conflicts of interest

As the European legislator the SEC sees the conflicts of interest problems that come with the remuneration models used by rating agencies. The issuer-pays and the subscriber-pays model are often used business models where the issuer-pays model is favorite. Both carry their own (potential) conflicts of interest. Perhaps the Hiring Agent model, which is proposed by the SEC in May 2011, could be a solution in the search for a better remuneration model. According to this model the issuer who needs a rating for a structured finance product is required to submit his request to a credit rating agency board. This board selects a NRSRO to provide the rating to the issuer. The board will evaluate the rating performance of the rating agency afterwards.[112]

The SEC draws specific attention in this matter to the conflicts of interest with regard to the structured finance area. It is of the opinion that the complexity of the products and issuers „ability to control the information concerning the underlying assets of these products lead to an informational imbalance, which together with the high concentration of rating agencies in this area of the market increases the potential conflicts of interest.[113]

Although legislators worldwide could not decide on mandatory rules to combat conflicts of interests, they are addressed under Section 931(4) of the Dodd-Frank Act:

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[111] U.S. Securities and Exchange Commission 2011, p. 5.
[112] Garcia Alcubilla, Ruiz del Pozo 2012, p. 248.
[113] U.S. Securities and Exchange Commission 2012, p. 31.

„In certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation in order to give clearer authority to the Securities and Exchange Commission'.

The question remains if rating agencies will in fact disclosure more information to the outside world.[114] The Dodd-Frank Act contains several provisions that address the conflict of interest. Based on section 932(a)(4) of the Dodd-Frank Act a rating agency is for example required to keep sales and marketing away from ratings. Credit rating agencies need to monitor conflict of interests and the SEC is required to establish an office within itself to supervise rating agencies.[115] With this last measure the Dodd-Frank Act follows the approach of giving the SEC increased oversight of the rating business started in earlier legislation.[116] Based on the same provision, NRSRO's need to have policies and procedures to address the potential for a rating agency to be influenced by an analyst that seeks employment with the entity that is rated, an issuer, underwriter etc. A „look-back-rule' is furthermore established which requires a rating agency to conduct a one-year look-back when an analyst leaves the rating agency to work for another party that is rated by the NRSRO.[117]

Of course other topics such as the overreliance, liability of rating agencies and sovereign rating also have their place at the table of the United States legislator. Based on the recent report of the SEC the focus of at least the last year (June 2010-June 2011) seems to have been mostly on the above mentioned subjects.

2.5 CONCLUSION

The current Euro crisis has shown again certain failures in the performance of credit ratings agencies, this time with regard to sovereign ratings. Times of crisis have highlighted the serious weaknesses in governance and general performance of gatekeepers such as credit rating agencies.[118] Many failures in different categories came to the surface. The European and American legislator have defined several specific issues with regard to these failures. For most of these issues several solutions are proposed. Most of them do not bring a solution but only reduce the problem. The question is however whether it is even possible to find a solution in some situations. Both the United States legislator and the European legislator try to find new balance through additional legislation. With most of their proposed solutions both the U.S. and European legislator try to improve legislation on credit rating agencies by focusing on more disclosure and transparency. The actions of both regimes can be labeled as rather defensive and reactive because the measures each time come afterwards. Legislators respond to the market and do not seem to have a very pro-active approach.

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[114] Darbellay, Partnoy 2012, p. 13 and 14.
[115] D.P.Cluchey, *The financial crisis and the response of the United States; will Dodd Frank protect us from the next crisis?*, Januari 1, 2001, p. 217 and 218.
[116] Darbellay, Partnoy 2012, p. 8.
[117] U.S. Securities and Exchange Commission 2011, p. 2.
[118] McVea 2010, p. 728.

Failures together with the fact that ratings play a very important role in the financial market created a sense of urgency with legislators worldwide, and formed the inducement for new and additional legislation and control with the legislators. Because so many different actors in the financial market use and rely on ratings these measures with regard to failures need to be taken.

3 DIFFERENCES IN THE AMERICAN AND EUROPEAN APPROACHES

Compared to the actions taken by the American legislator it can be said that the urge or the discussion on the European continent, to undertake some action with reference to credit rating agencies came somewhat later. It is only since a few years that the notion of legal regulation of the credit rating industry is there on both continents. The United States, but mostly the European regulator, seemed to have had enough reasons not to regulate this specific group of companies at first. One believed that the threat of the loss of reputation would be sufficient to achieve high quality standards with regard to rating activities. Besides that also national approval procedures for rating agencies should have contributed something to keep up these standards. A few years back the European legislator even agreed with the non-legislative solution preference expressed by the former Committee of European Securities Regulators (CESR)[119] in a reaction on the Code of Conduct Fundamentals for Credit Rating Agencies, published by the International Organization of Securities Commissions (IOSCO) in 2004.[120] The European Commission's approach with regard to regulation of credit rating agencies was based on this non-legislative preference and therewith based on the assumption that a combination of soft law, concern for reputation and market forces would ensure the integrity of ratings issued by credit rating agencies.[121] Time has shown however that the soft law approach and reliance on reputation did not achieve the high standards our society demands these days from rating agencies. In this chapter the development, as well as the focus points of both European and United States regulation with reference to credit rating agencies will be discussed.

3.1 AMERICAN LEGISLATOR'S APPROACH

3.1.1 Sarbanes-Oxley Act

Credit rating agencies were remained unregulated for a long time. However the first provisions that had influence on rating agencies in the United States can be found in the Sarbanes-Oxley Act. The worries with regard to the gate-keepers, including credit rating agencies, failure to identify and respond to accounting improprieties such as with Enron in 2001, led to §702 in the Public Company Accounting Reform and Investor Protection Act of 2002, better known as the Sarbanes-Oxley Act. This Act, in short, was established with the purpose of creating improvements in governance by inducing increased oversight and monitoring of companies.[122] This Act mostly addressed the problems of accounting irregularities. It established rules that for example enabled a shift of control of the accounting profession from the profession to a new body, the Public Company Accounting Oversight Board (PCAOB). The PCAOB thereafter became authorized to establish auditing standards,

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[119] Now the European Securities and Markets Authority (ESMA).

[120] S. Utzig, *The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective*, ADBI Working Paper Series, p. 1.

[121] A. Johnston, *Corporate Governance is the problem, not the solution: a critical appraisal of the European regulation on credit rating agencies*, Journal of Corporate Law Studies, October 2011, p. 402.

[122] J.A. McCahery, E.P.M. Vermeulen, *Corporate Governance of Non-Listed Companies*, Oxford University Press: New York 2008, p. 194.

impose professional discipline and regulate the profession.[123] The Sarbanes-Oxley Act also required the SEC to study the role of rating agencies and report to Congress with recommendations for additional regulation.[124] As a result of this requirement the SEC reported in 2003 on the role and function of rating agencies. Following this report and its outcomes Congress enacted the Credit Rating Agency Reform Act in 2006.[125]

3.1.2 Credit Rating Agency Reform Act of 2006

Credit rating agencies were criticized for failing to play their role of watchdog after scandals occurred such as Enron. Reform was adopted by Congress with the Credit Rating Agency Reform Act of 2006 (Reform Act).[126] The goal of this Reform Act was:

> *'to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit*'.[127]

The Reform Act adopted rules that established a regulatory program for specific rating agencies called NRSRO's. A rating agency can be called a Nationally Recognized Statistical Rating Organization or NRSRO when it provide ratings for regulatory purposes and is registered.[128] They can be compared with the European recognized European External Credit Assessment Institution (ECAI's) on which the European legislator until today relies for regulatory purposes. An example of one of the measures added by the Reform Act is Section 15E(a)(3) of the Exchange Act, which required the SEC to issue rules requiring an NRSRO to make certain information publicly available on its website or through another comparable, readily accessible means.[129]

The Credit Rating Agency Reform Act required the SEC to establish clear guidelines for determining which credit rating agencies qualify as NRSRO's, and standardized the registration process for NRSRO's. Besides that the SEC was given the task of financial reporting, record-keeping and general oversight responsibility for these rating agencies, and therewith the task of general oversight.[130]

The SEC, as many other regulators, today still heavily relies on ratings supplied by specific market-recognized credible rating agencies, something that started in 1975. The NRSRO ratings are still widely used for distinguishing among grades of creditworthiness in both federal and state legislation. Besides that they are used in rules issued by (financial) regulators and in some foreign regulations. The Reform Act contains rules that focus on the misuse of confidential information, the management of conflicts of interests and contains rules that ban

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[123] J.C. Coffee, Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, Working Paper No. 237, September 2003, p. 50.
[124] Cluchey 2001, p. 216.
[125] Securities and Exchange Commission 2003, p. 25.
[126] And inserted as s15E in *Securities Exchange Act* (1934) 15 U.S.C. §78 et seq.
127 S. Rousseau 2009, p. 18 and 19.
[128] Securities and Exchange Commission 2003, p. 5.
[129] U.S. Securities and Exchange Commission 2012, p. 25.
[130] Cluchey 2001, p. 217.

certain practices. Furthermore it established rules on the appointment of a compliance officer and rules on the general disclosure and disclosure of agencies financial development.[131]

The Reform Act prohibits the SEC however from regulating the substance of credit ratings, but also the substance of procedures and methodologies used by a rating agency to determine credit ratings.

3.1.3 Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act, (the Dodd-Frank Act) was enacted on July 21, 2010. It expanded the initiatives that came out of the Credit Rating Agency Reform Act, and contains statutory provisions applicable to credit rating agencies. Provisions with regard to credit rating agencies can namely be found in Subtitle C named: „*Improvements to the Regulation of Credit Rating Agencies*'.[132] The Dodd-Frank Act has in the past tried, and will in the future try to strengthen rules with regard to inter alia credit rating agencies. This Act required the SEC to adopt more regulatory measures in order to strengthen the regulation of NRSRO's activities.[133] It focuses, as seen in Chapter 2, in particular on conflicts of interest, transparency and competition in the market of rating agencies.

The Dodd-Frank Act gives regulators increased powers to set standards in the rating industry and tries to provide investors and regulators with more information about rating agencies. An example of these new measures is the fact that when a NRSRO performs serious shortcomings, it can be barred by the SEC. Besides that the SEC must implement rules that require the NRSRO to disclose their rating performance, rating agencies might need to further define the meaning of their rating symbols, and must be able to accompany each rating with a form of information on the rating methodologies. Among these provisions to enhance the disclosure and transparency, the Dodd-Frank Act also required the SEC to conduct examinations of each NRSRO annually and to issue a report summarizing its findings. The first reports of these examinations have been published.[134] Based on the results of the examinations further action is undertaken by the United States legislator in order to improve the integrity of the rating process. It can be expected that in the future more „Dodd-Frank-proposals' will see the light under the mandate that is established by the Dodd-Frank Act.[135]

3.2 EUROPEAN LEGISLATOR'S APPROACH

As with regard to American legislation, credit rating agencies were recognized by several directives, but remained unregulated creatures in the European Union for a long time.[136] After Enron debacle in 2001, the Economic and Financial Affairs Council (ECOFIN) in April 2002 requested the European Commission to assess the activities of credit rating agencies. The

[131] Utzig 2010 p. 7 and 8.
[132] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Subtitle C, Sec. 931-939H.
[133] Autorité des marches financiers 2011, p. 7.
[134] U.S. Securities and Exchange Commission 2012, p. 25.
[135] U.S. Securities and Exchange Commission 2011, p. 1.
[136] Directive 2003/125/EC (Market Abuse Directive 2006/48/EC (Capital Requirements Directive) and Directive 2004/39/EC (Markets in Financial Instruments Directive).

European Commission held several discussions in 2003 on the subject in the European Securities Committee (ESC). In February 2004, the European Parliament called on the European Commission to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals to deal with credit rating agencies.[137] The former Committee of European Securities Regulators (CESR) thereafter conducted a study for the European Commission that recommended that new legislation was not necessary to address the failings of credit rating agencies. Besides this recommendation the Commission relied on the international IOSCO Code of Conduct of 2006, that provided general guidelines and which favored self-regulation to ensure the accountability of rating agencies.

The process to review the compliance with the IOSCO Code at that time only contained three requirements. Firstly, an annual letter had to be send to the CESR in which the rating agency outlined how it had complied with the Code and in which it would indicate any deviations. Secondly, once a year, the CESR and the rating agencies would hold a meeting to discuss issues around the implementation of the IOSCO Code. And thirdly, the rating agency should provide the national CESR member with information if any substantial incidents would occur in the market.[138] This procedure was therefore not very comprehensive.

The CESR had to report annually on the rating agencies, but after a first CESR report noting that credit rating agencies generally complied with the Code, the European Commission rested its case. Improvements with regard to credit rating agencies were desirable at that moment, but the need for specific legislation remained unproven.[139] The IOSCO Code of 2006 was lastly revised in 2008. In order for investors and regulators to gain better insight into rating and avoid excessive reliance on rating agencies the Code was given special provisions that set out extensive disclosure requirements. There are still no specific provisions on methodologies in the Code.[140]

3.2.1 Regulation (EC) No 1060/2009

As a response to the credit crisis Regulation (EC) No 1060/2009 (Regulation) of 16 September 2009 came into force on 7 December 2009. There are some provisions in the Regulation that can also be found in the IOSCO Code, the difference is however that the Regulation is legally binding.[141] The primary goal of this Regulation was to protect investors and create stability in the market. Besides these primary goals, the Regulation tried to reduce conflicts of interests, improve the quality of ratings, and enhance the transparency and creation of an efficient monitoring and supervisory framework. The IOSCO Code but also the American Credit Rating Agency Reform Act were both an inspiration for this Regulation.[142] The Regulation established a system for registering credit rating agencies in the European

[137] Call to CESR for technical advice on possible measures concerning credit rating agencies.
[138] Utzig 2010, p. 8.
[139] Rousseau 2009, p. 20.
[140] Utzig 2010, p. 12.
[141] Utzig,2010, p. 15.
[142] J.J. Atema, Nieuwe regelgeving ten aanzien van credit rating agencies, Bb 2010, 42, p. 3.

Union and set out the rules of conduct for these agencies.[143] They key points and provisions in this Regulation are according to Utzig: provisions on the scope (banks are required to only use ratings for regulatory purposes), on registration and supervision of rating agencies and provisions on equivalence and endorsement (setting out a regime for recognizing third-country ratings equivalence). Also rules on the withdrawal of registrations and transition periods, provisions on structured finance (additional symbols to distinguish these ratings from other categories) and finally provisions internal governance and transparency.[144]

3.2.2 Amended Regulation (EU) No 513/2011

Increased financial problems in the first months of 2010 for several European member states accelerated the change of existing legislation on credit rating agencies. On the first of June 2011 Amended Regulation (EU) No 513/2011 of 11 May 2011 (Amended Regulation) came into force. The most important amendment was the fact that European Supervisory and Markets Authority (ESMA) became entrusted with the exclusive supervisory powers on credit rating agencies registered in Europe, that earlier was delegated by the Regulation to national authorities.[145] A development that was seen earlier in American legislation where the SEC was attributed the control and oversight by the Credit Rating Agency Reform Act.

3.2.3 Commission delegated regulation

The recently published Commission delegated regulation (EU) No 272/2012 of 7 February 2012 (Delegated regulation) supplements the Regulation with regard to fees charged by the ESMA to credit rating agencies. This Delegated Regulation lays down the rules regarding the fees that the ESMA shall charge to credit rating agencies for supervision, registration and certification activities.[146]

3.2.4 Regulatory technical standards on credit rating agencies

Besides the Delegated Regulation, on 30 May 2010 four new regulations with regulatory standards were published in the Official Journal of the European Union.[147] These standards go on and complement the current European regulatory framework and mostly the Regulation. The regulatory standards work out certain provisions of the Regulation with regard to:

- the content and format of ratings data and periodic reporting that needs to be submitted to the ESMA for the purpose of ongoing supervision;
- standards for the assessment of compliance of credit rating methodologies set out in Article 8(3) of the Regulation;
- standards for the presentation of the information (including structure, format, method and period of reporting) that credit rating agencies shall make available in a central repository (CEREP); and

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[143] Autorité des marches financiers 2011, p. 3.
[144] Utzig, 2010, p. 15 and 16.
[145] The European Supervisory and Markets Authority (ESMA) was established by the Regulation (EU) No 1095/2010.
[146] Commission delegated regulation (EU) No 272/2012 of 7 February 2012, Article 1.
[147] Commission Delegated Regulation (EU) No 446/2012, 447/2012, 448/2012 and 449/2012 of 21 March 2012.

- standards on information that needs to be provided to the ESMA as an application for registration and certification of credit rating agencies.

Still quite some issues are not sufficiently redressed in legislation. Examples of issues that still are not sufficiently addressed in legislation are; the high degree of concentration in the rating market, the risk of overreliance on credit ratings by financial market participants, civil liability of credit rating agencies versus investors, conflicts of interests with regard to the issuer-pays model and the credit rating agencies' shareholder structure and finally sovereign ratings.[148]

3.3 SUBCONCLUSION

Until a decade ago credit rating agencies both in Europe and the United States were recognized but unregulated. During the last ten years, encouraged by the financial crisis and problems in the financial sector, regulation on rating agencies popped out of the ground on both the U.S. and in Europe and there does not seem to be an end in sight. It can be said that the European legislator for a few years longer than its U.S. counterpart relied on the assumption that combination of soft law, concern for reputation and market forces would ensure the integrity of credit ratings. It relied a relatively longer time on the guidelines of the international IOSCO Code of Conduct before establishing the first Regulation.

At the moment several issues are not sufficiently redressed in legislation such as: the high degree of concentration in the rating market, the risk of overreliance on credit ratings by financial market participants, civil liability of credit rating agencies versus investors, conflicts of interests with regard to the issuer-pays model and the credit rating agencies' shareholder structure and sovereign ratings. It can be expected that more regulation with regard to these issues will appear soon.

3.4 DIFFERENCES BETWEEN UNITES STATES AND EUROPEAN LEGISLATION

In May 2010 the formerly Committee of European Securities Regulators (CESR) published a technical advice for the European Commission on the equivalence between the United States regulatory and supervisory framework and the European regulatory regime for credit rating agencies.[149] According to the CESR overall, the United States legal and supervisory framework could be considered broadly identical to the European regulatory regime for credit rating agencies when looked at:

„the overall objective of assuring that users of ratings in the EU would benefit from equivalent protections in terms of the credit rating agencies integrity, transparency, good governance and

[148] European Commission, Proposal for a regulation of the European parliament and of the council *amending Regulation (EC) No 1060/2009 on credit rating agencies*, 15-11-2011, 2011/0361 (COD), p. 2.
[149] Committee of European Securities Regulators 2010, p. 1.

reliability of the credit rating activities'. But there are of course differences.[150] Below a few of these differences are exposed.

The CESR starts of in its report with a overall remark that they noticed a general difference in the philosophy and approach in regulation and supervision of credit rating agencies in the United States compared to the approach and vision in Europe. It makes a distinction between seven specific areas.[151] The approach in the United States relies according to the CESR for instance heavily on upfront and detailed disclosure being made during the application process. The American legislator therewith trusts on the market's ability to make its own assessment with regard to quality that rating agencies produce.[152] From the moment the rating information is published, the review and control system in the United States relies on the SEC. The SEC therewith carries out their supervision on an ex-post basis. When failure by a rating agency is noticed on disclosure, the agency may be subject to liability under the federal securities laws and rules there under.[153]

The CESR is of the opinion that in Europe the philosophy in this regard is somewhat different. According to them there is no philosophy of publicly disclosing the application form and the information provided to support it. European regulation on rating agencies instead contains, and is based on very detailed descriptions of rating procedures and processes that agencies need to have ready upfront, but also needs to be taken into consideration by rating agencies during the rating procedure. Besides that there is an expectation that the competent authority and the market make their own assessment of what is, and what is not an „adequate' procedure. This results in the fact that Europe's approach can be labeled as a more ex-ante supervision and that it has rating by rating disclosure requirements. The CESR therefore concludes that Europe relies more on ex-ante supervision to identify potential problems.[154]

As said, the CESR determined seven specific areas or categories when it compared the American legislation to its European counterpart in 2009. The areas are the following: the scope of the regulatory and supervisory framework, corporate governance, conflicts of interest management, organizational requirements, quality of methodologies and quality of ratings, disclosure and finally effective supervision and enforcement. The CESR found „differences of note' in two specific areas namely „corporate governance' and „conflicts of interest management'. In two other areas bigger differences and gaps were identified. These differences were translated into the report as „weaknesses'. These differences were labeled as weaknesses and were especially found in the category „quality and methodologies of ratings' and in the category „disclosure'.[155] In the three remaining categories only slight differences

[150] Committee of European Securities Regulators 2010, p. 4.
[151] These seven areas are: the scope of the regulatory and supervisory framework, corporate governance, conflicts of interest management, organizational requirements, quality of methodologies and quality of ratings, disclosure, effective supervision and enforcement.
[152] Committee of European Securities Regulators 2010, p. 55.
[153] Committee of European Securities Regulators 2010, p. 4 and 5.
[154] Committee of European Securities Regulators 2010, p. 42.
[155] Committee of European Securities Regulators 2010, p. 161 and 162.

were of found, and the CESR concluded that American and European law in these three categories could be considered broadly equivalent. This is the reason why the attention below goes out to the four areas where this was not the case and where notable and substantial differences were found by the CESR.[156] These four areas can give a better picture of the differences in detail between both legal regimes with regard to credit rating agencies.

3.4.1 Corporate governance

The first difference in American legislation with respect to the area of corporate governance noticed by the CESR when comparing American with European legislation on rating agencies, is the fact that the requirements for NRSRO's in the United States are governed by State law. It is therefore possible that each state has different variations with regard to this part of the law and therewith a different approach in this matter. The second matter that is noticed by the CESR concerns the monitoring of supervisory requirements. According to American legislation senior management shares the responsibility with a designated compliance officer for ensuring compliance with relevant laws and regulations, as well as the credit rating agencies' internal policies. The compliance officer is responsible for administering the procedures. These procedures concern the management of conflicts of interest and the prevention of the misuse of material confidential information. This officer also ensures that a rating agency sticks to the policies and procedures and complies with the requirements of both the Exchange Act and the SEC Rules.[157]

American legislation does not require rating agencies to have independent members of the board of directors or the supervisory board. The compliance officer is instead responsible for these monitoring tasks, which the European legislator requires to be carried out by such independent members. Furthermore there is no requirement in American legislation for an independent compliance officer. The CESR however assumes that the independence of this individual is something that the examination office would need to examine. This matter might indicate that a credit rating agency in the United States does not need to have reasonably designed procedures for managing conflicts of interest and preventing the misuse of non-public material information. Despite these differences the CESR is of the opinion that the potential negative consequences that might come out of the different approach taken by the American legislator are sufficiently mitigated in the United States through the supervision of the SEC supervision.[158]

3.4.2 Conflicts of interest management

As with the rules on corporate governance, the CESR considers the requirements in United States law with regard to the conflicts of interest management to be particularly strong and robust. It is of the opinion that, besides some differences, these rules overall meet the

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[156] What needs to be said is that the CESR report is from 2009, the Dodd-Frank Act and the Restoring American Financial Stability Act of 2010 were later implemented. These acts might have compensated several differences in European and American legislation in de meantime.
[157] Committee of European Securities Regulators 2010, p. 66 and 67.
[158] Committee of European Securities Regulators 2010, p. 67.

objectives of the European requirements.[159] The following matters were however noticed when comparing the United States and European legislation in terms of the conflicts of interest management.

There is to begin with no explicit requirement in American federal law that enforces a rating agency to organize itself in a manner that ensures that its business interest does not impair the independence and accuracy of its credit rating activities.[160] In contrast with the European legislator who prescribes that:

„credit rating agencies should establish appropriate internal policies and procedures in relation to employees and other persons involved in the credit rating process in order to prevent, identify, eliminate or manage and disclose any conflicts of interest and ensure at all times the quality, integrity and thoroughness of the credit rating and review process. Such policies and procedures should, in particular, include the internal control mechanisms and compliance function'.[161]

It is in the United States furthermore not necessary to publicly disclose the names of the rated entities or related thirds parties from which a rating agency receives more than 5% of its revenue. Disclosure can only be made to the regulator, who will monitor and supervise how rating agencies manage the conflict of interests.[162] The European Regulation on credit rating agencies on the other hand does require rating agencies to publicly disclose the names of the rated entities or related third parties from whom it receives more than 5 % of its annual revenue.[163]

Another example concerns the disclosure of large clients. In the United States information regarding the twenty largest clients of a rating agency needs to be provided to the SEC. A rating agency may however require that the SEC keeps the report confidential to the extent permitted by law. Subsequently, there is no requirement in American legislation with regard to rating agencies to list ancillary services in the final rating report, in contrast to Annex I, Section B.4 of the European Regulation, which states that credit rating agencies are prohibited from providing consultancy or advisory services.[164]

Finally, there is no requirement in American legislation to have a gradual rotation policy for the credit ratings agencies' rating analysts, like is proscribed by Article 7.4 and Recital 33 of the European Regulation. This provision provides that rating agencies are required to establish an appropriate gradual rotation mechanism with regard to rating analysts and persons approving credit ratings.[165]

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[159] Committee of European Securities Regulators 2010, p. 89.
[160] Committee of European Securities Regulators 2010, p. 80.
[161] Regulation (EC) No 1060/2009, Recital 26.
[162] Committee of European Securities Regulators 2010, p. 25.
[163] Regulation (EC) No 1060/2009, Annex I, Section B.2.
[164] Committee of European Securities Regulators 2010, p. 85.
[165] Committee of European Securities Regulators 2010, p. 83.

3.4.3 Quality of methodologies and quality of ratings

In contrast to the former two areas the CESR noticed bigger differences between the European and the American legislation in the area of quality of methodologies and quality of ratings. Notable is that the CESR concludes that in these specific areas the requirements set by the United States legislator do not meet the objectives of the European requirements.[166]

The CESR states that the SEC does not regulate the content of procedures and methodologies to determine credit ratings, and therewith does not review the content of the disclosure that is made by the specific form (Form NRSRO). Fact is that the SEC can do this but only later, on an ex-post basis during examinations. The CESR apart from this concludes that the United States regulatory framework has no legal requirements for a rating agency to monitor the methodologies and that is has no requirements to have a review function.[167] With respect to the quality of credit ratings and analysis of information that is used in assigning credit ratings, the American legislator furthermore has not created specific requirements, in contrast to European legislation.[168] There are for instance no requirements that a credit rating agency has to refrain from issuing a specific rating or withdraw an existing rating if it does not have sufficient quality information on which it can base its credit ratings.

Additionally, there are also no specific requirements in American legislation that deal with the desirability to use rating methodologies that are rigorous, systematic, continuous and subject to so-called validation based on historical experience and back testing as described in the European Regulation.[169] Something which the European legislator finds important and requires rating agencies registered in Europe to do based on Article 8(3) of the European Regulation.[170]

The CESR concludes therefore that it mostly comes down to the market that needs to do its own judgment with regard to the quality of methodologies and ratings used and produced by rating agencies.[171] The market itself needs to evaluate the quality of credit ratings and methodologies. The CESR is of the opinion that the differences in approach between the United States and Europe are there for a reason. They can be linked to the United States' approach to non interference with methodologies to determine credit ratings and with the substance of credit ratings, as described above.[172] The differences in legislation in this specific area can therefore be a result of the general differences in the philosophy and approach in the regulation and supervision of credit rating agencies between the United States and European regime.

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[166] Committee of European Securities Regulators 2010, p. 114.
[167] Committee of European Securities Regulators 2010, p. 104.
[168] Regulation (EC) No 1060/2009, Article 8.2 Article 8.5, Article 6 and Annex I Section A paragraph 9.
[169] Committee of European Securities Regulators 2010, p. 115.
[170] Regulation (EC) No 1060/2009, Article 8(3) and Recital 23.
[171] Committee of European Securities Regulators 2010, p. 100 and 101.
[172] Committee of European Securities Regulators 2010, p. 108.

3.4.4 Disclosure

In general it can be said that there are two types of disclosure requirements in the European Regulation. Firstly, the requirements relating to the disclosure that a credit rating agency needs to make on a rating by rating basis, and secondly disclosure relating to the credit rating agency itself.[173] As with the quality of methodologies and quality of ratings requirements, the CESR considers that „disclosure' is an area where significant differences exist between the European and American requirements adopted to achieve the overall objectives set by the European legislator (the objectives that form the starting point of the comparison). Despite some differences the CESR is of the opinion that the American legal and supervisory framework, overall, achieves the objectives of the European requirements that relate to disclosure regarding the credit rating agency and its activities. It concludes on the other hand that the disclosure of credit ratings does not meet the objectives of the European requirements.[174]

The following weaknesses were identified by the CESR when the US legislation was compared to the objectives in European legislation;

- there is no requirement for an unsolicited credit rating to be clearly identified as such, the information is only available to the SEC but not to other actors in the market;
- there are no requirements for a rating agency to disclose on a rating by rating basis whether or not a rated entity or financial product participated in the process for determining an unsolicited credit rating, and if a rating agency had access to the rated entity's books and records;[175]
- there is no requirement in the American legislation on rating agencies to explain the key elements underlying the credit rating when announcing a specific rating;
- there are no requirements to disclose information about the specific sources that were used and were substantially material in the determination of a specific credit rating;
- there is no requirement to disclose limitations and attributes of individual credit ratings;[176]
- there is no requirement for a distinct labeling of ratings for structured finance products, they are therefore difficult to recognize;
- and finally, there is no requirement to disclose on a rating by rating basis information about the level of assessment conducted by a rating agency on for example the due diligence process.[177]

[173] Committee of European Securities Regulators 2010, p. 7.
[174] Committee of European Securities Regulators 2010, p. 7 and 8.
[175] Committee of European Securities Regulators 2010, p. 137.
[176] Committee of European Securities Regulators 2010, p. 138.
[177] Committee of European Securities Regulators 2010, p. 139.

The European legislator is of the opinion that credit rating agencies should disclose information to the public on the methodologies, models and key rating assumptions which they use for their rating activities. According to Recital 25, the level of detail concerning the disclosure of information models should be formed in a way that it gives adequate information to all the users of ratings in a way that they can perform their own due diligence and make their own judgment when assessing whether to rely or not on those credit ratings.[178]

Although the paragraphs above might give the impressions that the American legislation on credit rating agencies is far behind or much less stringent in certain matters, it should be said that only a few of the differences in legislation are addressed in the above. There are in reality much more facilities that are the same or facilities that achieved the same goals but in a different way. The CESR finally mentions in its report that potential amendments under the bill of „Wall Street Reform and Consumer Protection Act of 2009' and the bill of „Restoring American Financial Stability'(better known as the Dodd-Frank Act today) could significantly change its findings in the future.[179]

3.5 CONCLUSION

Credit rating agencies both in Europe and the United States have remained unregulated for a long time. Now that they become more and more regulated it is possible to identify some differences in the development an approach of rating agencies through legislation when we compare the European Union and the United States.
It can firstly be concluded that the United States legislator in the past acted quicker than its European counterpart with regard to the development of legislation on credit rating agencies. Firstly because the European legislator relied for several years longer on the assumption that combination of soft law, concern for reputation and market forces would ensure the integrity of credit ratings. It relied therefore longer on the guidelines of the international IOSCO Code of Conduct, before establishing the first European Regulation on credit rating agencies.

Secondly, the United States legislator already in 2002, under the Sarbanes-Oxley Act, established a shift of control with regard to the gatekeepers (being a shift from the accounting profession to a new body, the PCAOB) and in 2006 under the Credit Rating Agency Reform Act empowered the SEC with oversight responsibilities. It took the European legislator until 2009 to create legally binding rules and until 2011 to entrust the ESMA with the exclusive supervisory powers.

Furthermore it can be concluded that the European and United States regime on credit rating agencies have a different philosophy and a different approach in the regulation and supervision of credit rating agencies. The biggest differences between the United States legal and supervisory framework and the European regulatory regime, mainly comes down to the area of disclosure of credit ratings and the quality of credit ratings and credit rating methodologies when we look in detail at legislation of both regimes. The CESR is of the

[178] Regulation (EC) No 1060/2009, Recital 25.
[179] Committee of European Securities Regulators 2010, p. 114 and 115.

opinion that most of the differences mentioned in their report are there for a reason. These differences can be linked to the United States' approach to non interference with methodologies to determine credit ratings and with the substance of credit ratings. Most of the differences in legislation in these areas are in the end a result of the general differences in the philosophy and approach in the regulation and supervision of credit rating agencies between the United States and European regime. The approach in the United States relies according to heavily on upfront and detailed disclosure being made during the application process. The European approach on the other hand can be labeled as a more ex-ante supervision with rating by rating disclosure requirements.

Notwithstanding all of the above mentioned differences, the CESR overall concludes that the United States legal and supervisory framework can be considered broadly identical to the European regulatory regime for credit rating agencies. The law on this matter develops quickly and differences can be gone before we know it. American and international legislation thereby form an inspiration for the European legislator.

All these differences or „weaknesses' described above were a result of a comparison of two regimes in 2009. It goes too far to check whether all these weaknesses mentioned by the CESR still exist today despite new regulation. More interesting is to see where in the past and most likely today the differences in the approach by both regimes were and still are. Fact is that it can be expected that these differences will be reduced enormously in the future. By addressing the differences between both legislations in 2009 the CESR namely hoped to achieve further convergence between both regimes.[180] It can be expected that the expectations of the CESR are similar to the view and expectations of the European Commission and perhaps even the United States legislator.

[180] Committee of European Securities Regulators 2010, p. 4.

4 DISCUSSION AND RECOMMENDATIONS

The previous chapters gave an insight into the world of credit rating agencies. They provided some historical background of rating agencies, provided an explanation of their rating activities and additional services performed by these agencies. Problems and spillover effects created by these activities were explained and lastly a short oversight of the approach in legislation was given. Most of these matters were seen through the eyes of both the European and the United States legislator, and were compared where possible. This chapter will focus on the solutions proposed by legislators and others and contains several conclusions and recommendations.

4.1 SOLUTIONS WITH REGARD TO 'EUROPEAN ISSUES'

In Chapter 2 it was concluded that the European legislator relied for a few years longer than its U.S. counterpart on the assumption that a combination of soft law, concern for reputation and market forces would ensure the integrity of credit ratings. It relied therewith, as said, a relatively longer time on the guidelines of the international IOSCO Code of Conduct, before establishing the first Regulation. Garcia Alcubilla en Ruiz del Pozo noticed in their book that after the financial crisis which started in the summer of 2007, the first tangible reaction of the European legislator was adding extra provisions on structured finance ratings to the IOSCO Code of Conduct in order to strenghten it.[181] Now three years later, in recovery of the Euro crisis which placed the sovereign ratings in the spotlights, the European legislator again reacts by creating proposals to add legislation, this time on sovereign ratings. In my opinion it can therefore be concluded that the current regulatory approach of the European legislator can be characterized by constantly adding legislation in reaction to problems and uncertainties that surround rating agencies. Its approach can therefore be labeled as reactive.

As mentioned in Chapter 2 the following issues are currently on the agenda of the European legislator: overreliance on ratings, competition, liability of credit rating agencies, conflicts of interest, sovereign debt rating and transparency of rating methodologies and processes.[182] If we want to ascribe these issues to a specific regime, it is possible to label the following subjects as more „European issues'. These three issues are: overreliance on ratings, liability of credit rating agencies and sovereign debt rating. The reason that these issues can be labeled as European issues is that they are currently not explicitly mentioned on the „shortlist' of the U.S. legislator that is described in Chapter 2. The other issues (competition, transparency and conflicts of interest) which are on this shortlist of the U.S. legislator can therefore be labeled as more „common issues'.[183] These common issues will be discussed below. It speaks for itself that of course all six issues to a greater of lesser extent do play a role in the United States. It is only for this assessment that that the distinction is made.

[181] Garcia Alcubilla, Ruiz del Pozo 2012, p. 246.
[182] European Commission 2011.
[183] U.S. Securities and Exchange Commission 2012..

4.1.1 Overreliance on ratings

In Chapter 2 several solutions for the overreliance problem are mentioned by Klinz in the report for the European Commission.[184] Klinz first of all suggest that small players on the rating market should only be allowed to use external credit ratings if they can fully understand the risks involved and can conduct a proper due diligence. This is not a bad idea, but one that might be very difficult to shape into legislation, because it might be difficult to decide when a small player fully understands everything. This solution would call for more regulation and more requirements, which is not desirable per se.

Secondly, an increase in disclosure of information and the ability to do due diligence and risk assessment in order for market participants to do their own evaluation models is proposed. Thirdly, it is suggested that financial institutions and institutional investors should end their heavy relies on external ratings. Although more will be said about disclosure and transparency below, increased disclosure brings with it the risk that agencies will be buried under legislation. A further increase in regulatory measures to disclose could threat competition in the market for smaller rating agencies and newcomers.

With regard to the last suggestion it is good to notice that measures have been taken to prevent that financial institutions like the European Central Bank remain depend on external ratings in the future. Basel III, as discussed in Chapter 1, is in that regard a good example.[185] It should however be said that it is questionable whether reducing the reliance on external ratings will help in the long run. Suitable alternatives for ratings should be there first in order for it to be successful. Larger market players such as financial institutions and larger institutional investors can replace external ratings with internal assessments, but for smaller players this will be difficult.

4.1.2 Liability of credit rating agencies

The lack of civil liability regimes in some member states of the European Union and the risk of regulatory arbitrage currently prevent the European legislator from moving to a stricter liability regime.[186] The European Parliament however is in favor of exposing rating agencies to a stricter liability regime in case of gross negligence or misconduct. It is of the opinion that credit ratings should not be classified as opinions and that they should be not be treated in the same way as other gatekeepers.[187] Garcia Alcubilla en Ruiz del Pozo proof a good point with their argument that a more stringent liability regime would not only result in several technical difficulties on implementation, but apart from that might also cause an extra barrier to entry and other unintended consequences.[188] These authors mention also two other arguments against stricter liability rules. The first one is that when overreliance would be reduced, actors in the financial markets could lose a potential argument that they need a proper legal recourse (and therewith stricter liability measures) for rating inaccuracy. The second one is that creation of stricter rules on liability could give participants in the financial market an additional argument not to do their own research. They could easily turn to liability

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[184] Klinz 2010.
[185] Bank for International Settlements 2010, p. 4 under 15.
[186] European Commission, Commission Staff Working Paper 2011, p. 3.
[187] Garcia Alcubilla, Ruiz del Pozo, 2012, p. 256.
[188] Garcia Alcubilla, Ruiz del Pozo 2012, p. 256 and 257.

allegations instead.[189] Because there are so much unintended consequences and uncertainties surrounding the qualification of a rating, creation of a stricter liability regime would perhaps even harm the current financial market more than it would do any good. Also because ratings are so absorbed by all actors in the financial market. Rating agencies could for instance stop with specific ratings or can become reluctant to deviate from the general opinion. It would not be wise to change matters in this regard on short notice in my opinion, without further international clarity on the qualification of ratings.

4.1.3 Sovereign debt rating

Lack of objectivity, completeness and appropriateness of rating methodologies and processes, the lack of transparency, the level of qualification and expertise of the staff and lastly the inappropriate timing of rating publications, make that sovereign debt rating has become an important issue on the list of the European legislator.[190]

Rules and regulations on this specific type of rating activity should be treated separately from other rating activities, because the potential spillover effects can be larger and more extensive in comparison with other rating activities. This type of rating is so sensitive (seen for instance the consequences of a downgrade of a country or large banks) that it is questionable whether these activities should belong to a private party. However a long as we do not have an alternative for these ratings, disclosure with regard to sovereign ratings should be as broad as possible so that parties as the SEC and the ESMA are able to check the state of affairs.

When sovereign rating activities are however banned from current rating agency performances, it would be undesirable to move these activities for instance to a public rating agency. This is because the interests of public rating agencies in that case will always conflict with political interests of countries and governments that are rated. When for instance a European public rating agency would be established that has the intention to downgrade the United States as a country, that could immediately cause political tensions. A shift of sovereign rating activities to an international organization instead of a private or a public company could solve most of the political conflicts. Proposals of the European legislator meanwhile are not that innovative. Improvement of the methodologies, monitoring and transparency with regard to ratings is currently their solution to this issue. It is therefore perhaps better that these ratings, while the market is used to them and until any alternative comes up, are established and published by an independent private firm, despite the current issues and conflicts of interest.

4.2 SOLUTIONS WITH REGARD TO 'COMMON ISSUES'

The United States legislator was earlier occupied with credit rating agencies than the European legislator by establishing provisions in the Sarbanes-Oxley Act of 2002. Not so strange since this regime was also confronted earlier with the first problems (such as Enron) that occurred in this field. As explained in Chapter 3, the Dodd-Frank Act of 2010 nowadays mandates the SEC to develop legislation with regard to credit rating agencies. The Act gives

[189] Garcia Alcubilla, Ruiz del Pozo 2012, p. 257.
[190] Garcia Alcubilla, Ruiz del Pozo 2012, p. 258.

regulators increased powers to set standards in the rating industry and tries to provide investors and regulators with more information about rating agencies. It is therefore expected that the United States legislators and policymakers during the upcoming years will continue to try to increase a better oversight regime for credit rating agencies.[191]

The following issues could be labeled as „common issues' since they appeared in papers and proposals of both the European and the United States regulator.

4.2.1 Competition

The limited scope of competition in the rating agency market can be labeled as one of the issues that might have contributed to the incorrect functioning of rating agencies in the past.[192] High market concentration together with high barriers of entry and lack of comparability of ratings are often mentioned as the reasons behind this issue by the European legislator. The SEC, together with researchers such as Partnoy, is of the opinion that regulatory use of ratings also attributed to barriers of entry and therewith complicated competition.[193]

In the consultation for the European Commission with regard to credit rating agencies several solutions are proposed to reduce competition problems.[194] The first one being the establishment of a fully independent non-public (European) credit rating agency. Furthermore the establishment of a new network of (small and medium-sized) European credit rating agencies and the possibility to make two ratings from two different agencies obligatory (for structured finance products) is suggested.[195] This last suggestion could work but could increases the costs of ratings.

Lastly, it is suggested to entrust the ECB or other national banks with the task to issue ratings.[196] A remark with this suggestion is that there is a possibility that these parties are not completely independent. These institutions can be pressured by politics and besides that their current work could conflict with rating activities. The question apart from that is whether attracting more actors to the market (such as banks or perhaps a public rating agency) would improve the functioning of established rating agencies, and therewith the general quality of credit ratings. These new participants might lose the competition with established agencies when it comes to reputation, economies of scale and experience. Garcia Alcubilla and Ruiz del Pozo are of the opinion that regulators should focus on transparency instead of focusing on increasing competition.[197] The point that these authors make can be agreed with to a certain point. Because when increased transparency provisions reveal procedures used by established rating agencies of bad quality there should be new participants in the market with new methodologies to choose from. When barriers to entry remain in place these parties will not be there and there will be nothing to choose from. Transparency in that regard than does not work.

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[191] Garcia Alcubilla, Ruiz del Pozo 2012, p. 245.
[192] Garcia Alcubilla, Ruiz del Pozo 2012, p. 245.
[193] Securities and Exchange Commission 2003, p. 16 an 17.
[194] Klinz 2010.
[195] Klinz 2010, p. 9 and 10.
[196] Garcia Alcubilla, Ruiz del Pozo 2012, p. 254.
[197] Garcia Alcubilla, Ruiz del Pozo 2012, p. 255.

4.2.2 Transparency

During the last couple of years the United States legislator established several provisions to increase competition. A registration process was designed to make it easier for rating agencies to become a NRSRO, furthermore additional disclosure requirements were enacted such as the disclosure of performance statistics, disclosure of procedures and methodologies, on conflicts, on the history of ratings and lastly procedures for protecting material, non-public information.[198] As the European legislator, the United States legislator therewith seems to have its focus on disclosure and transparency. Fostering transparency together with accountability and competition in the rating agency industry is important for the United States legislator.

As described in Chapter 2, increased disclosure requirements also carry the danger that comes with these extra measures and may result in the fact that rating agencies are buried by legislation. The costs of ratings could be increased and rating agencies could decide to stop performing less profitable or time consuming tasks. This increase in regulatory measures furthermore could threat competition in the end because smaller rating agencies and newcomers to the market will have more difficulty getting by with all these requirements. Legislators need to watch out for this effect. Perhaps they should make a distinction between types of ratings with regard to disclosure. Because it might not be necessary for rating agencies to disclose as much information for certain types of ratings which for instance can be checked relatively easy by consumers. For instance unsolicited ratings would require more transparency than solicited ratings.

4.2.3 Conflicts of interest

The European legislator mentions several solutions for reducing of the conflicts of interest that come with the remuneration model of credit rating agencies.[199] The conflicts of interest that come with the issuer-pays model could be battled by prohibiting credit rating agencies to provide advisory services next to rating activities. Fact is however that these additional services might generate a large share of the revenues of rating agencies. Revenues that might be necessary to deliver high quality ratings. It is therefore possible that the prohibition to perform other services has a negative influence on the general performance of rating agencies and the general quality of ratings.[200]

Furthermore it might help to create a board of directors with (more) independent to help address the disadvantages caused by conflicts of interest.[201] A good idea. European legislation already contains requirements with regard to this idea, it is a relatively small requirement that could work out very well in practice. The development of a new remuneration model besides

[198] U.S. Securities and Exchange Commission 2012, p. 23.
[199] Klinz 2010.
[200] Garcia Alcubilla, Ruiz del Pozo 2012, p. 248.
[201] Klinz 2010, p. 11.

the issuer-pays and subscriber-pays model could also be a possible solution when trying to reduce the conflicts of interests.[202]

Garcia Alcubilla and Ruiz del Pozo are not convinced that mandating one business model over others will result in a benefit. They believe that the European legislator should focus on ensuring an appropriate level of regulatory monitoring and accountability for all credit rating agencies. They advocate for more supervision and enforcement.[203] These authors touch a new point in the whole discussion on legislation of rating agencies with their opinion. Perhaps it is time for the European and United States legislator to stop focusing and reacting to new upcoming problems by adding more and more legislation and shift the focus to providing sufficient rules for supervision and enforcement of existing rules. Some problems in the end cannot be solved by legislation. Perhaps these issues can be reduced to an acceptable level when rating agencies know there being watched closely.

4.3 CONCLUSIONS AND RECOMMENDATIONS

Why and how do the American and European legislators try to get more control over credit rating agencies; can they learn from each other, and are there alternatives besides more (national) legislation?

With regard to legislation on credit rating agencies it can overall be concluded that regulation of rating agencies has had an enormous boost in the last couple of years. New legislation and addition provisions are added weekly in the reviewed regimes. Currently, both the U.S. and European legislator try to improve legislation on credit rating agencies by adding more rules focusing on more disclosure and transparency. In that regard mostly structured finance ratings and sovereign ratings are high on the agenda. It can therefore also be concluded that credit rating agencies moved from an unregulated surrounding of self-regulation to a far stricter regime with extensive legislation and oversight by public authorities in the last couple of year.[204]

The United States legal and supervisory framework furthermore can be considered broadly identical to the European regulatory regime for credit rating agencies, although there are several differences in the formation of legislation. The European legislator is of the opinion that American legislation met the EU requirements adopted to achieve the overall objectives set by the European legislation. This does not mean that they can not learn from each other. The experiences of the European legislator with regard to sovereign ratings can for instance be a basis for American legislation. It is in that regard very important that both regimes cooperate. It would not be helpful if legislation in certain matters would diverge.

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[202] Autorité des marches financiers 2011, p. 7.
[203] Garcia Alcubilla, Ruiz del Pozo 2012, p. 261 and 262.
[204] Garcia Alcubilla, Ruiz del Pozo 2012, p. 260.

It subsequently it can be concluded that both regimes have several identical issues with regard to rating agencies on their agenda but there are also issues that have more attention in a specific regime such as the discussion on sovereign ratings in Europe.

Finally it can be concluded that both the European and U.S. legislators mostly react to upcoming issues with regard to credit rating agencies by creating new proposals and therewith by using legislation. The actions of both regimes can be labeled as rather defensive and reactive instead of proactive and forward thinking with a long-term strategy.

When it comes to recommendations the following points could be addressed. First as mentioned a few times earlier, the European and United States legislator should be careful in the future with establishing too much additional legislation for credit rating agencies. Although not all the issues mentioned are addressed by legislation at the moment, most of them are and it is not clear whether additional or new legislation could solve all the matters. Some aspects like the conflicts of interest might never completely disappear and as shown by the several remuneration models, each new model again brings its own conflicts with it.

It would furthermore be good in my opinion if both regimes would start the discussion and a reach agreement on the qualification of ratings and credit rating agencies. Should they be qualified as gatekeepers or should they be treated separately. I believe that the uncertainty with regard with regard to the status of rating agencies slows legislators down in their reaction and supervision of credit rating agencies.

Finally, the European and United States legislator need to revise whether there is enough sufficient legislation for supervision and enforcement of the current rules on credit rating agencies. Perhaps it is time to shift the focus from the current issues to supervision and enforcement.

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