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The Reform of the Credit Rating Agencies: A Comparative Perspective

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Credit ratings are a quasi-public good, and investors and financial markets regulators need an independent assessment of the credit-worthiness of an issuing entity because of information asymmetries and principal agent problems. In light of the high volatility of market-based measures and the failure of internal risk management, private CRAs are best fit for purpose. However, natural barriers of entry in the rating business and conflicts of interest have led to an inflation of ratings and a deterioration in their quality. It would thus appear that CRAs need closer supervision. While certainly burdensome and likely to raise barriers of entry, the European Commission's proposal seems to be the most sensible solution given the circumstances. Market discipline based on competition and transparency as envisioned in the US will lead to a weak surveillance regime, while leaving the regulatory license intact.

1. Introduction

The credit rating industry is a global business, with three leading players (Moody's, Standard & Poor's, and Fitch) controlling over 94% of the global market (European Commission 2008b). Credit rating agencies (CRAs) sit at the centre of international capital markets. Until recently CRAs were seen as neutral information providers, capable of objectively assessing the credit risk of a certain entity or debt security. From the early 1990s on, however, CRAs have been increasingly criticised. From the 1994 Mexican Tequila Crisis to the 1997-98 Asian Financial Crisis; from the 2001 Enron Scandal to the 2003 Parmalat bankruptcy, CRAs have been blamed for failing to warn investors of imminent corporate or sovereign default. The anger directed at these agencies indicates the degree of power CRAs enjoy in financial markets. The role of CRAs in the subprime financial meltdown in exacerbating the financial crisis has become startlingly clear, and yet investors and the financial press still discuss ratings widely. As capital markets have become increasingly global, so has the dominance of the leading CRAs.

This Policy Brief argues that credit ratings are a quasi-public good, and that investors and financial markets regulators need an independent assessment of the credit-worthiness of an issuing entity because of information asymmetries and principal agent problems. In light of the high volatility of market-based measures and the failure of internal risk management, private CRAs are best fit for purpose. However, natural barriers of entry in the rating business and conflicts of interest have led to an inflation of ratings and a deterioration in their quality. Thus, it would appear that CRAs need strict supervision. While certainly burdensome and likely to raise barriers of entry, the European Commission's proposal seems to be the most sensible solution given the circumstances. Market discipline based on competition and transparency as envisioned in the US will lead to a weak surveillance regime, while leaving the regulatory license intact.

This paper is organised as follows. The second part briefly discusses the academic literature concerning credit ratings. The third part compares the US and EU regulatory frameworks. The fourth part analyses the differences in regulation in light of the previous theoretical discussion and the final part draws conclusions.

2. Theoretical Framework

Although credit ratings are widely used and figure prominently in the financial press, no consensus on the reasons for such success exists. Some argue that credit

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ratings contain no meaningful information, and are widely used only because of regulation; others contend that ratings are unavoidable because they balance accuracy with stability. Are credit ratings opinions or regulatory actions? The following section serves as a theoretical introduction to understanding why credit ratings exist, examines their use in capital markets and the issues with the leading agencies' current business model.

2.1 Credit Rating Agencies

What exactly are credit rating agencies, and why do credit ratings exist? In spite of the mounting interest and growing body of literature on CRAs, the answer to these two ostensibly simple questions is hard to find. According to the International Organization of Securities Commissions (IOSCO), "a credit rating is an assessment of how likely an issuer is to make timely payments on a financial obligation" (IOSCO, 2003, p. 3).[1] Are credit ratings therefore nothing but opinions on the credit-worthiness of an issuing entity? This is what the agencies themselves successfully argue in US courts when seeking legal protection under the First Amendment from liability for their ratings.

Table 1. Key figures for the 'Big Three'

	Total Assets	Turnover	Net Income	Operating Margin	Market Capitalisation	Business model	Corporate governance	Number of employees
Moody's Corporation						Issuer-pays	Publicly-owned	
2002	$630	$1,023	$288	28.15%	$6,899			2,100
2007	$1,714	$2,259	$701	31.03%	$10,063			3,600
Standard and Poor's						Issuer-pays	Private	
2003	n/a	$1,700	n/a	n/a	n/a			5,000
2006	n/a	$2,750	n/a	n/a	n/a			8,500
Fitch						Issuer-pays	Private	
2003	n/a	$505	$59.8	11.84%	n/a			1,502
2004	n/a	$561	$62.1	11.06%	n/a			1,661

Sources: S&P website; Moody's K-10 Filings; OSIRIS; Hoover's

Yet others dispute the notion of CRAs as pure analysts, and point to the quasi-regulatory role ratings have in financial markets (Kerwer, 2005). Because rating decisions have an important impact on credit flows, the leading agencies – the argument goes – are tantamount to informal regulators. Some have argued that a look at the companies' profitability confirms that CRAs are more than "financial gatekeepers" (Partnoy, 2006). For example, Moody's revenues and profits more than doubled over 2002-2007 from $1,023 and $288 million in 2002 to $2,259 and $710 million, respectively; its market capitalisation in 2007 was $10 billion in spite of having only $1.7 billion in assets. Other financial gatekeepers such as accounting and financial publishing firms face different competitive landscapes. On the one hand, accounting firms are legally liable for their actions, resulting in litigation costs and hefty settlement payments. On the other hand, competition in financial publishing is much stronger compared to the credit rating industry.[2]

There are also conflicting views on the reason for the success of credit ratings. The prevalent view is that credit ratings are useful in reducing *information asymmetries* between issuers and buyers of debt securities. Thanks to their access to privileged information on the issuer, the agencies can verify the obligor's financial ability to repay its debt. In particular, small investment firms and unsophisticated investors – lacking the resources to establish large research departments – gain from the economies of scale of the leading CRAs. Another view holds that credit ratings help mitigate *principal-agent problems* by lowering the cost of monitoring agents (Gonzales et al., 2004, pp. 7-8). For instance, since asset managers do not have sufficient incentives to curb excessive risk-taking, investors can with contractual obligations 'tie the hands' of asset managers by forcing them to purchase only rated debt or, in some instances, only investment-grade securities.[3]

However, some of the empirical academic literature is sceptical about the role of credit ratings in providing

[1] The three leading rating agencies agree with this definition. "Moody's credit rating are opinions of the credit quality of individual obligations or of an issuer's general creditworthiness" (Moody's, 2008, p. 1); "A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program" (S&P, 2008, p. 3); "Fitch's credit ratings provide an opinion on the relative ability of an entity to meet financial commitments, such as interest, preferred dividends, repayment of principal, insurance claims or counterparty obligations" (http://www.fitchratings.com/corporate/fitchResources.cfm?detail=1, accessed January 20, 2009).

[2] Significant financial publishing firms are: Dow Jones, Thomson-Reuters, Pearson PLC (owner of *Financial Times* and *The Economist*), Bloomberg, Associated Press, and smaller companies such as FactSet and Interactive Data.

[3] An international long-term security is considered investment-grade if it has a rating above BBB- (S&P and Fitch) and Baa3 (Moody's).

useful information to investors. Hull, Predescu and White (2004) find that credit default swap spreads and bond yields largely anticipate the information contained in ratings' changes. Cantor and Mann (2003) show that market-based measures such as bond spreads are more accurate in predicting short-term default risk than credit ratings. Nevertheless, credit ratings remain useful because they balance accuracy and stability, sacrificing some predicting power for lower volatility (Löffler, 2004). Moreover, market-based measures may not be reliable for illiquid securities and lesser-known companies for which little public information is available.

Whether one considers credit ratings as opinions or quasi-regulatory actions has important economic, political and regulatory consequences. These will be analysed in greater detail in section 4. Let us now turn to three important theoretical issues concerning the agencies' business model: governance, transparency and competition.

2.2 Governance

The three leading credit rating agencies are for-profit organisations. Moody's Corporation is the NYSE-listed holding company of Moody's Investor Service (for simplicity: Moody's); the American publisher NYSE-listed McGraw-Hill is the owner of Standard & Poor's (S&P), which does not have separate disclosure requirements; and finally the French financial company Fimalac listed on Euronext Paris as the majority owner of Fitch, which has two headquarters in New York and London.[4]

The most prominent issue with the agencies' governance is their 'issuer-pays' business model. During the 1970s, CRAs switched to the 'issuer-pays' model from a 'subscriber-pays' model because of increasingly complex securities in need of large resources, and the fear of declining revenues resulting from the dissemination of private ratings through new information technologies. Nobody raised concerns at the time. However, amid heightened criticism following the 1994 Mexican crisis and the 1997-98 Asian Financial crisis, CRAs have come under intense scrutiny (IMF, 1999, p. 136). Since the 1990s when emerging economies' borrowings expanded rapidly, sovereign and corporate ratings have become much more prominent in international bond markets. Critics pointed to the inherent conflict of interest in the 'issuer-pays' business model, whereby agencies would value profits over ratings' quality. In particular, because the agencies are paid by the entities that are the object of the judgement, CRAs would be under pressure to maintain market share by inflating ratings. This criticism re-emerged after the WorldCom and Enron collapses in the early 2000s. In spite of mounting calls for the regulation of the industry, CRAs successfully fended off the attacks by arguing that keeping their reputation intact was a sufficient incentive to manage their conflicts of interest. The fact that US courts recognised ratings as 'opinions', and granted them free speech protection from liability under the First Amendment certainly helped to avoid supervision (Partnoy, 2006, pp. 94-95).

Another important governance issue is whether credit rating agencies should perform due diligence with regard to the information received by the issuer. Generally, CRAs do not check the information they are given, and they rate securities on the assumption that the data are correct (SIFMA, 2008, p. 5). For instance, in 2001 S&P and Moody's both rated Enron as investment-grade until four days before the energy company declared bankruptcy – based on the misrepresentations of Enron's executives. In the example of residential mortgage-based securities (RMBS), CRAs relied on flawed information provided by originators concerning underlying pools of subprime mortgages (Fitch, 2007).

2.3 Transparency

In theory, transparency should help to evaluate CRAs' performance by reducing monitoring costs, and it should reduce over-reliance on ratings. For instance, disclosing rating methodologies and critical assumptions underlying ratings allows users to check whether the rating is fair and the analysis accurate. Moreover, it helps users understand the meaning of ratings and their possible shortcomings. Finally, it would encourage users to perform their own research based on the information made available.

Transparency should also increase competition. For example, disclosing information regarding the accuracy of the ratings may help to sanction those agencies that do not meet certain criteria. Some may argue that too much transparency may harm innovation. Why should rating agencies develop new methodologies if they are forced to disclose their efforts?

In the case of structured products, CRAs have used the same rating scale as corporate bonds, without releasing information on liquidity and volatility risk and on the uncertainties in pricing highly complex securities. As a consequence, triple-A senior tranches of collateralised debt obligations (CDO)[5] had – in the eyes of regulation and of less informed investors – the same degree of risk

[4] For detailed information on market shares, revenues, and legal structure of the agencies in the European market, see Annex 9.4 of European Commission (2008b).

[5] Collateralised debt obligations are securities issued by special purpose vehicles on an underlying pool of fixed-income assets. Fixed-income assets can be credit card debt, corporate loans or bonds, residential or commercial mortgages or asset-backed securities. CDOs are divided in tranches with different levels of seniority, with senior being the highest. In case of difficulty in repayments on the underlying pool of debt, the most senior tranches are those that are paid first: from there the lower risk of default and higher rating.

as triple-A corporate bonds.[6] As it turned out, the statistical models used to calculate the ratings of structured products were based on excessively thin samples and optimistic assumptions on default probabilities. Some have proposed that the agencies utilise different rating scales in light of the different nature of corporate bonds and complex securities. But originators – actors with a vested interest in the survival of securitisation – fiercely oppose such measures, arguing that it would represent a 'stigma' on structured securities.

2.4 Competition

The credit rating industry is oligopolistic with the three leading agencies controlling over 94% of the global market (European Commission, 2008b). In theory, competition ensures innovation, and it represents a healthy check on product quality. However, the rating business is entirely based on reputation. A certain contradiction between competition and reputation exists. The reputational capital the leading CRAs enjoy is enormous – the result of almost a century of successful activity. Investors trust CRAs' judgement and they ask for a certain risk premium based on the issuer's rating. Even after the subprime debacle, rating decisions are widely discussed in the financial press, highlighting their continuous importance. The same way a three-star Michelin restaurant can charge inflated prices for its food, highly-rated issuers can charge high prices for their bonds, resulting in lower interest rates.

Because reputation is costly to establish and maintain, there is a 'natural' barrier of entry in the rating industry. Some argue that the so-called 'regulatory license' reinforces the oligopolistic nature of the rating industry (Partnoy, 1999). Remove ratings from regulation, the argument goes, and competition will result. Users will consider ratings for what they are – opinions – and they will be free to choose what value to assign to them. According to this view, rating opinions are so important precisely because they are 'hardwired' in global regulation. For instance, 'credit triggers' – clauses in loan covenants tied to ratings – bolster the value of ratings, in so far as companies must consider rating actions or face a loss of credit. Another example is Basel II where banks can choose the so-called Standardised Approach to calculate the risk-weighted capital requirements based on ratings of recognised External Credit Assessment Institutions (ECAIs).[7]

However, despite criticism of low informational content, there is evidence that investors use and value ratings, regardless of present regulation. In a recent survey of asset managers in the US and Europe, Cantor et al. (2007) find that only 21% of respondents used ratings because they were mandated by regulation, while 59% of respondents used ratings because they were mandated by clients. Moreover, some respondents trusted ratings for pursuing a good investment strategy (25%). Thus, this seems to indicate that ratings are perceived to be a tool both to reduce information asymmetries between issuers and buyers, and to mitigate principal-agent problems. Considering that almost all the fund managers in the study cited Moody's (98% of respondents), S&P (97%), and Fitch (70%) as rating agencies present in clients' guidelines, this points to the high level of trust enjoyed by the incumbent CRAs. Indeed, the reputational barriers of entry to the business are extremely high.

3. Regulation

US regulation has employed credit ratings since the 1930s without supervising CRAs. This dependence has certainly grown from the 1970s onwards. By contrast, EU regulation has only recently started to use ratings. The US enacted a regime of surveillance in 2006, while the EU intends to do so shortly. The following section overviews the supervisory frameworks of credit rating agencies in the US and Europe, and takes a look at the use of ratings in present regulation on both sides of the Atlantic.

3.1 US Approach

US regulation became entangled with credit ratings during the 1930s, in response to the 1929 market crash. The Comptroller of the Currency issued the first act incorporating ratings in legislation in 1931, and the Federal Reserve followed in 1935 and 1936 (Partnoy, 1999, pp. 686-690). Between the 1930s and the 1970s the use of ratings in regulation did not change significantly. Amid the credit crises of the early 1970s, the Securities and Exchange Commission (SEC) amended Rule 15c3-1 in 1975 to make capital requirements for brokers-dealers more risk sensitive, introducing for the first time the official denomination of Nationally Recognized Statistical Ratings Organization (NRSRO) (SEC, 1975). Since then, US regulation has grown to be highly dependent upon ratings in areas such as securities, pensions, banking, real estate, and insurance (Partnoy 1999, p. 690). While the SEC failed to formally specify the criteria to assign NRSRO status, the term was widely used in state and federal regulation. Moreover, four CRAs that were recognised as NRSRO were eventually acquired by the three main CRAs, leading to a de facto state-sanctioned oligopoly (SEC, 2003, p. 9).

The ambiguity in the NRSRO registration process persisted up to the Credit Rating Agency Reform Act of 2006, when Congress decided to act to inject competition and transparency in the rating industry. The legislation was the logical consequence of the perceived failure of credit rating agencies to predict the Enron bankruptcy of

[6] A qualification is in order. Interest rates spreads paid on triple-A CDOs have been consistently higher than on triple-A corporate bonds. Market-based measures had been more prescient than ratings.

[7] Although some minor agencies are recognised in some jurisdictions, Fitch, S&P and Moody's are universally recognised as ECAIs across Europe and Asia.

2001 because of gross negligence. In section 702(b) of the Sarbanes-Oxley Act of 2002, Congress asked the SEC to issue a report on the role and function of CRAs in securities markets (SEC, 2003). The report's main conclusions were that enhanced registration and oversight of CRAs were needed, and that increased transparency and competition would benefit the quality of ratings and represent a check to potential conflicts of interest. The Credit Rating Agency Reform Act of 2006 (US Congress, 2006) aimed at these objectives by granting rule-making, supervisory and enforcement powers to the SEC in order to oversee the credit rating industry, which was previously unregulated. Let us analyse the provisions in detail.

Rating agencies that *wish* to be recognised as NRSRO apply to the SEC, furnishing information on:

1) ratings' performance
2) procedures and methodologies to calculate ratings
3) policies to safeguard confidential information
4) organisational structure
5) code of ethics
6) conflicts of interest
7) 20 largest clients
8) and written certifications on the part of "qualified institutional buyers" stating that they have used the agency for at least 3 years.

The SEC may revoke or suspend the license if the CRA no longer satisfies the criteria of the initial application or in case of misuse of non-public information and/or infringement of conflicts of interest provisions. Moreover, it can impose sanctions if the NRSRO fails to maintain adequate financial and managerial resources. The NRSRO has to submit updates on the information delivered in case of any change as well as an annual report certifying the accuracy of the information. The statute explicitly forbids the SEC from issuing rules concerning the substance and the methodologies of the ratings. The SEC's rule-making powers relate to: the prevention of misuse of non-public information; the management and disclosure of conflicts of interest; and the avoidance of unfair, coercive or abusive competitive practices. The Act also mandates that each NRSRO designate a compliance officer, and that it provide a confidential financial statement to the SEC.

Based on the authority granted by the Credit Rating Agency Reform Act of 2006, the SEC proposed six rules on 2 February 2007, adopting the final rules on 23 May 2007. The final rules determine the details of the application process, and they establish that a NRSRO should keep a record of rating actions, internal documents, auditing materials, and internal and external communications. The NRSRO or its employees should not use confidential information for personal profit, and the NRSRO should set policies and procedures to manage and disclose conflicts of interest defined as (1) issuer-pays model (2) ancillary services (3) subscriber-pays model (4) employee owns any stake in a company rated by another employee (5) excessive involvement of an employee with the entity subject to rating. NRSROs should not (1) rate an entity whose business represents more than 10% of its total net revenue (2) rate an entity if the NRSRO or an employee involved in the rating decision own any stake in the company rated (3) rate an entity associated with themselves. As far as unfair, coercive, or abusive practices are concerned, a NRSRO should not tie the performance of its services to the purchase of other services, and should consistently use its preset procedures and methodologies independently from the services purchased by the rated entity (SEC, 2007).

In light of the 2007-08 global financial crisis and mounting evidence of the responsibility of CRAs in the debacle, the SEC decided to propose a new, more stringent set of rules on 16 June 2008 and 1 July 2008 regarding disclosure, conflicts of interest and reduction of reliance on ratings in regulation.[8] In a nutshell, the proposed rules: envision CRAs as 'gatekeepers' in disclosing extensive information on structured securities and statistics on performance of ratings; prohibit CRAs from providing advisory services; forbid analysts involved in rating decisions to negotiate fees and/or to receive gifts; keep records of deviations from models and third-party complaints; differentiate ratings for structured products; and, finally, to eliminate references to ratings in broker-dealers, money markets and other investment companies' regulation. Some of the rules proposed are controversial. For instance, prohibiting NRSROs from engaging in any type of advisory services was considered excessive. By the same token, CRAs have criticised their proposed role as gatekeepers in disclosing information, arguing that the burden should fall on originators. Finally, both originators and CRAs oppose using different symbols for structured securities.

3.2 European Approach

European Union legislation only recently started using ratings. The first piece of Community law explicitly mentioning CRAs was the market abuse regime's implementing Directive 2003/125/EC, in which the agencies are *encouraged* to establish policies and procedures to ensure that ratings are fairly presented and disclose conflicts of interest. However, it was not until the Capital Requirements Directive (CRD)[9] that European legislators incorporated ratings in the law in order to assess the risk related to a certain financial assets. According to the CRD, EU financial institutions can use ratings of recognised ECAIs to calculate on a

[8] For an excellent summary of the proposed rules, refer to http://www.chadbourne.com/clientalerts/2008/creditratings (accessed 28 January 2009).

[9] Directive 2006/48/EC, this directive implements the Basel II capital requirements.

risk-weighted basis their minimum capital requirements. The recognition mechanism for ECAIs is described in Annex VI Part 2 of the CRD, whereby the rating agency should abide by standards of objectivity, independence, ongoing review, credibility, and transparency (European Commission, 2008a, p.4). However, the recognition mechanism did not grant any rule-making, supervisory or enforcement powers to ECAIs, as specified by the Committee of European Banking Supervisors, or CEBS (CEBS, 2006, p. 1).

In spite of the lack of formal regulation, the European Commission had been monitoring the credit rating industry closely. In particular, in July 2004 – in response to a European Parliament resolution in February 2004 after the Enron and Parmalat scandals – the Commission asked the Committee of European Securities Regulators (CESR) for technical advice on possible avenues to supervise CRAs. CESR concluded that there was no need for formal regulation. In January 2006, the Commission agreed to these conclusions, but requested that CESR submit a yearly report of the implementation on the part of CRAs of the voluntary IOSCO Code of Conduct (IOSCO 2004).[10] As it became increasingly clear that CRAs played an important role in the ongoing financial crisis and that self-regulation was no longer a viable solution, in July 2008 the Commission decided to undertake the legislative path, issuing a consultative paper followed by a formal Regulation proposal in November 2008 (European Commission, 2008a). The Commission wishes the proposal be adopted by the Council in March 2009.

The proposal takes the form of Regulation,[11] and sets four broad principles as the main objectives:

1) avoidance, or at least adequate management, of conflicts of interest
2) improvement of the quality of ratings and methodologies
3) enhanced transparency
4) efficient registration and surveillance.

The proposal follows the Lamfalussy procedure, so that its details can be decided at the 'comitology' level. The Regulation would apply to rating agencies used for regulatory purposes, and banks and investment firms would use for capital calculations only ratings issued by registered CRAs. Moreover, ex art 4(2) investment firms and credit institutions "should not execute orders on behalf of their clients" in regard to financial instruments rated by unregistered CRAs. This provision seems to imply that they may still deal on own account and engage in discretionary portfolio management when trading securities rated by unregistered CRAs, but they may not use such ratings in capital calculations.

Among other rules contained in the legal text, CRAs should: avoid any conflict of interest; ensure its employees have sufficient knowledge and expertise; prohibit analysts from discussing fees with rated entities; establish a rotation mechanism; set compensation schemes rewarding accuracy; exercise due diligence with regard to the information received; record all downgrades and justification for such actions; review ratings in light of new macroeconomic conditions; immediately disclose changes in rating methodologies and review and re-rate past ratings in light of the new methodologies; either differentiate the rating scale for structured securities or provide a detailed report on the underlying assumptions; disclose policies and procedures for unsolicited ratings; identify unsolicited ratings with a different rating category; disclose detailed information on ratings' performance; and, finally, publish a transparency report annually.

As far as the registration process is concerned, CRAs that wish to be registered with the community must establish a subsidiary within the territory, and submit a registration to CESR. CESR will then transmit the registration to the home member state of the main subsidiary of the CRA and to other host member states with branches on their territories. The proposal mandates that home and host member states cooperate on registration, supervision and enforcement matters under the umbrella of CESR. The proposal also outlines in detail the powers of competent authorities, and sets principles relating to the sanctions applicable to CRAs in breach of the law. Finally, the proposal asks CESR to issue guidelines on implementation of the Regulation in order to achieve consistent application of the law across the EU territory.

Two annexes are attached to the legal text that can be modified at level II by the Commission with the assistance of the European Securities Committee (ex art 33(1)). The annexes contain rules on conflicts of interest and on the information that must be provided with the registration. A CRA's supervisory board should include at least three non-executive independent members whose compensation is not tied to the company's financial performance.

[10] Both US and EU regulation reflect the principles contained in the IOSCO code. The main weaknesses of the code were the excessively general character of its principles and its lack of sanctions beside the usual 'comply or explain' approach of self-regulation.

[11] Regulation implies that once the legislation is adopted by the Council, it takes immediate effect across the Community following the publication in the Official Journal of the European Union.

Table 2. Comparison between US and EU supervision of CRAs

	Registration	Oversight	Conflicts of Interest	Transparency	Competition	Governance	Methodology
US (The Credit Rating Agency Reform Act of 2006 and SEC final and proposed Rules)	Registration at the Security and Exchange Commission (SEC) as Nationally Recognized Statistical Rating Organization (NRSRO). Application includes information on: 1. ratings' performance 2. procedures and methodologies 3. policies against misuse of private information 4. organisational structure 5. code of ethics 6. conflicts of interest 7. 20 largest issuers or subscribers 8. certification of institutional investors that the ratings are considered significant	The SEC has sole responsibility for supervision. The SEC has no say in the ratings' substance, procedures and methodologies. The SEC can suspend or limit operations or revoke the license if the NRSRO does not comply with the regulation or fails to maintain adequate resources to produce valid ratings.	Appropriate policies and procedures to manage and address conflicts of interest. The SEC has the authority to issue rules concerning conflict of interests related to: 1.Compensation 2.Consulting and advisory services 3.Personal and ownership conflicts 4.Affiliation with issuers 5.Other conflicts of interest the SEC deems necessary; prohibit an NRSRO from issuing a rating where the NRSRO or a person associated with the NRSRO has made recommendations as to structuring the same products that it rates; prohibit anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it, to prevent business considerations from undermining the NRSRO's objectivity; prohibit gifts from those who receive ratings to those who rate them, in any amount over $25.	Periodic private disclosure of financial conditions Require disclosure by the NRSROs of whether and how information about verification performed on the assets underlying a structured product is relied on in determining credit ratings. Require disclosure of how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings. Require NRSROs to make an annual report of the number of ratings actions they took in each ratings class. Require documentation of the rationale for any material difference between the rating implied by a qualitative model that is a "substantial component" in the process of determining a credit rating and the final rating issued. Require NRSROs to differentiate the ratings they issue on structured products from other securities, either through issuing a report disclosing how procedures and methodologies and credit risk characteristics for structured finance products differ from other securities, or using different symbols, such as attaching an identifier to the rating.	Require NRSROs to make all of their ratings and subsequent rating actions publicly available, to facilitate comparisons of NRSROs by making it easier to analyze the performance of the credit ratings the NRSROs issue in terms of assessing creditworthiness. Require NRSROs to publish performance statistics for one, three and ten years within each rating category, in a way that facilitates comparison with their competitors in the industry.	Prohibit an NRSRO from issuing a rating on a structured product unless information on the characteristics of assets underlying the product is available, in order to allow other credit rating agencies to use the information to rate the product and, potentially, expose a rating agency whose ratings were unduly influenced by the product's sponsors. Prohibition of use of non-public information for profit	/
EU (Commission's Proposals SEC (2008)2745 and SEC (2008)2746)	CRAs whose ratings are used in regulation should be registered Single registration for the Community Coordination of CESR for the registration process Info for the registration 1. full name of the credit rating agency, address of the registered office within the Community; 2. name and contact details of a contact person; 3. legal status; 4. class of credit ratings for which the credit rating agency is applying to be registered; 5. description of the procedures and methodologies used to issue and maintain credit ratings; 6. policies and procedures to identify and manage conflicts of interests; 7. information regarding employees; 8. compensation arrangements; 9. ancillary services; 10. programme of operations,	Convergence of sanctions across Member states CRAs headquartered outside the Community must establish a subsidiary within the Community.	CRAs should limit their activities to issuing of credit ratings; ancillary services are permitted only if conflicts of interest do not arise. CRAs should establish policies and procedure to ensure conflicts of interest are properly managed. CRAs should try to avoid conflicts of interest. If conflicts of interest are unavoidable then they should be managed. Records of potential conflicts of interest as well as safeguards against those threats must be kept. CRA or its employees shall not rate an entity if they own a stake in the company.	Either use different ratings for structured products or clearly disclosing information on the different types of risk Updates of methodologies must be disclosed before these enter into effect. All changes should lead to a review of previous ratings Disclose policies and procedures for unsolicited ratings Disclose information on rated entity whose business represents more thant 5% of annual revenue Present ratings with extensive information on assumptions, people involved, limitations Disclose rules on conflicts of interest, definition of ancillary services, compensation schemes, methodologies, 20 largest clients and largest contributors to company's growth		No preliminary rating assessment is allowed. Rotation of analysts is required. CRA's supervisory boards should include at least three independent, non-executive members whose remuneration shall not be dependent on the agency's performance. Adequate financial and human resources must be dedicated to monitoring, updating, and issuing of credit ratings.	Methodologies should be rigorous, systematic, continuously updated and backed by historical data. The CRA should ensure that the information provided by the issuer is reliable. Ratings should be reviewed in light of new macroeconomic conditions.

A CRA should establish an independent review function competent to periodically review methodologies and the adequacy of those methodologies to new financial instruments. A CRA should also disclose information on rated entity whose business represents more than 5% of its annual revenue. Other measures include: a CRA or its employees should not rate entities if they own a stake in the company that is the object of the judgement; a CRA should not provide consultancy services; a CRA should keep records of activities and communications for 5 years; a CRA should ensure its employees do not misuse private information; a CRA should present the rating decision with extensive information on underlying assumptions, people involved, the meaning and the methodologies used, and its limitations. Regarding disclosure, a CRA should disclose publicly its rules on conflicts of interest, its definition of ancillary services, its compensation schemes, its methodologies, its 20 largest clients and its largest contributors to the company's growth. The following information is required for the registration:

1) legal status, addresses and contact personnel
2) rating procedures and methodologies
3) policies to identify and manage conflicts of interest
4) information regarding employees
5) compensation arrangements
6) ancillary services.

4. Regulatory Analysis

As evidenced by the above description of the European and American supervisory frameworks towards CRAs, the Commission's proposal ("the proposal") stands in stark contrast to The Credit Rating Agency Reform Act ("the Act") of 2006 and subsequent SEC's final and proposed rules. First, in spite of the proclaimed search for US-EU cooperation and some convergence in the actual and proposed rules, the underlying objectives of the regulatory interventions are very different. Second and somewhat consequently, the proposal goes far beyond the Act in regulating the agencies, and it is a step towards cementing the status quo. As far as the objectives are concerned, the Act aims at injecting competition into the rating industry, while the proposal aims at enacting a regime of strong surveillance.[13] Both share the goals of transparency and accountability, but the proposal seeks accountability through enforcement whilst the Act seeks accountability through market discipline. The divergent goals are the result of different analyses of the rating industry and of different degrees of faith in the market. In order to understand the dissimilar approaches, it is necessary to step back for a moment and consider the logic behind the interventions.

Information goods such as credit ratings may be considered quasi-public goods, which are by definition non-rivalled and non-excludable. Non-rivalled means that the consumption of the good does not reduce its availability to others; non-excludable means that no-one can be effectively excluded from using the good. The property of non-excludability in credit ratings emerged with the widespread use of information technologies capable of reproducing and disseminating the ratings at virtually no cost.[14] If credit ratings are quasi-public goods, then the government should be in charge of providing them (public-utility model). However, governments are themselves in conflict because CRAs must rate sovereign entities. Market-mechanisms are generally better at insulating themselves from political pressure than government entities. Moreover, heavy state intervention may hamper innovation in the production of ratings. Thus a free market in the demand and supply of information seems to be the only optimal solution to provide credit ratings. Arguably the inclusion of ratings in regulations since the 1930s in the US and since the early 2000s in the EU amounts to outsourcing the production of the public good 'credit ratings' to private entities.

There are two opposing views of the functioning of the credit rating industry: the "reputational capital" view and "regulatory license" view (Partnoy, 1999). The reputational capital view contends that the rating industry is competitive and reputation-driven. The three leading CRAs have acquired the trust of investors thanks to their meaningful analyses contained in ratings, and investors demand lower or higher interest rates based on ratings, which reflect the credit-worthiness of the rated entities. Reputation ensures that the agencies maintain ratings' quality for fear of losing the trust of investors and, as a consequence, market shares. By contrast, the regulatory license view argues that since ratings are embedded in regulation, CRAs do not sell information but regulatory licenses. The regulatory license allows the rated entity to enjoy some benefits with respect to regulation. In spite of the low informational content, ratings remain meaningful because they are present in regulation. Moreover, state registration of CRAs increases barriers of entry, reinforcing the value of the license.

In the eyes of US regulators, the regulatory license view is an accurate depiction of the present state of the credit rating industry. The Act aims at re-establishing a situation whereby the reputational capital view would prevail. Put differently, US authorities are convinced that they can create a competitive, reputation-based credit rating industry, in which different opinions compete to

[13] Some elements of surveillance are present in SEC rules but not to the extent of the Commission's proposal.

[14] One can argue that subscription-based CRAs can overcome the problem of non-excludability. However, the most successful CRAs employ the 'issuer-pays' model to prevent the dissemination of ratings (free-rider problem) and to ensure sufficient revenues to cover the costs of analysing an ever-expanding array of financial instruments.

gain the trust of investors. By lowering barriers of entries, enhancing transparency and removing the regulatory license, competition will follow. The same way newspapers compete to establish their reputation as authoritative observers of politics and business, so should CRAs strive to provide accurate opinions on the credit-worthiness of issuing entities. Some economists are equally convinced that competition is the right answer to solve the issues with CRAs (Portes, 2008; Goodhart, 2008). Others argue that ratings should have a warning signalling that they are detrimental to one's financial health, in a similar fashion to packets of cigarettes (de Grauwe, 2009). However, there is a fundamental dilemma that these visions fail to address. No replacement for credit ratings in regulation exists. Credit default swaps (CDS) spreads and bond yields are extremely volatile, and they would exacerbate the pro-cyclicality of financial regulation. Additionally, the lack of liquidity of CDS and bonds in certain segments of the market represents a further obstacle in replacing credit ratings. If regulation aims to remain risk-sensitive without exasperating the business cycle, credit ratings are here to stay and so is the regulatory license.

Although the US solution is optimistic in envisioning a fundamental restructuring of the credit rating industry, the European approach represents a seal on the status quo. The stringent supervisory regime suggests that European authorities do not see any alternative to the 'regulatory license' scenario. Tellingly, 'competition' is not even mentioned as an underlying objective of the proposal, while it figures prominently in the title of the Act. By outsourcing the production of the public good 'credit ratings' to private companies, the Commission is convinced that it must closely monitor their actions and provide governance guidelines in order to ensure the quality and accuracy of the information. The organisation and conduct of business requirements are burdensome, and are likely to raise barriers of entry in the industry. The proposal interferes with the agencies' business model, also providing standards for their methodology. By contrast, the Act explicitly forbids the SEC from interfering with the content and methodologies of ratings.

However, if credit ratings are a quasi-public good – and we are convinced that they are – the position of the Commission is defendable on several fronts. First, as discussed above, risk-sensitive regulation requires measures that balance accuracy with stability. No realistic alternative to credit ratings balancing these objectives exists. Second, self-regulation has failed to ensure the accuracy of ratings, leading to rating inflation and poor performance. Third, 'natural' barriers of entry in the rating industry are high. Incumbent CRAs enjoy enormous reputational capital, regardless of the regulatory license. For instance, an absence of 'red tape' in the European market in the 1990s did not see the emergence of significant European competitors to the leading CRAs. Fourth, competition and reputation are at odds. Provided that the rating industry is based on reputation, it is unlikely that significant competition will arise because the market tends to coalesce towards two or three highly-reputed agencies. Were significant competition to arise and with it decreasing margins, CRAs would be tempted to lower prices and ratings quality to gain market shares (Becker & Milbourn, 2008). In a nightmare scenario, issuers would shop around for ratings among several competitors, looking for the highest one. And if authorities are incapable of removing the regulatory license, then banks and investment firms would choose those ratings that allow them to retain the lowest capital ratios, regardless of quality. This scenario would represent a threat to financial stability. Since credit ratings must be incorporated in legislation, public authorities have the duty to set minimum criteria for CRAs. Doing otherwise would represent a complete abdication of responsibility.

That said, several criticisms could be brought to the details of the proposal. First, the proposal should outline general principles in the legal text concerning conflicts of interest, governance, and disclosure, and then specify detailed rules in the annexes. In that way, it would provide more flexibility for possible changes because the annexes can be modified at Level II without the involvement of the Parliament and the Council. But there are several instances in which the legal text is extremely detailed and rule-based such as arts 6(4), 7(4) and (5), and 8(3) and (5). Second, by regulating CRAs so heavily, the Commission may give the impression of certifying ratings. However, ratings cannot be relied upon completely. Investors should make their own risk assessments, using credit ratings as one of the factors to be included in the investment decision. To this end, the Commission should undertake initiatives to educate investors on the limitation of ratings, and to reduce dependence on ratings. Nevertheless, mounting complexity and diversity in financial products rather than regulation may be the prime cause of over-reliance on ratings because investors do not have the expertise or resources to research on each product. Moreover, risk management departments of investment firms have emerged heavily battered from the ongoing financial crisis. This weakens the argument for relying more on risk management and less on external credit assessment. Overall, it appears that credit ratings are necessary in today's financial markets.

To summarise, in a world of information asymmetries, principal-agent problems, mounting complexity and diversity of financial products, network economies due to the nature of the rating business and the necessity of risk-sensitive regulation, external credit assessment appears unavoidable. While it is likely to raise barriers of entry, the Commission's proposal aims at restoring confidence in the production of credit ratings and set minimum governance standards for CRAs.

5. Conclusion

Credit ratings are necessary for risk-sensitive regulation, and to reduce information asymmetries and principal-agent problems in financial markets. Private CRAs are best-suited to providing independent assessments of the credit-worthiness of an issuing entity. However, natural barriers of entry in the rating industry and widespread conflicts of interest have led to a deterioration in the quality of ratings. Self-regulation and market discipline have not worked. Although the European Commission's proposal cements the status quo by further raising barriers of entry in the industry, it appears as the only viable solution. The competition and transparency envisioned in the US are likely to result in a weak surveillance regime, while leaving the regulatory license intact. Because ratings balance accuracy with stability, no viable alternative exists. Increasing competition may reduce the reputational incentives to ensure the quality of ratings. Moreover, the widespread failure of internal risk management in the banking sector suggests that reducing the role of external ratings in regulation is risky. Thus, strong provisions and a strict surveillance regime to police rating agencies are appropriate. There is nevertheless room for some improvement of the Commission's approach, such as increased flexibility in the governance rules mandated for CRAs, concerted efforts to educate investors on the limitation of ratings, and initiatives to ensure that ratings are not the sole parameter in the investment decision.

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The European Capital Markets Institute (ECMI) was established as an independent non-profit organisation in October 1993, in a collaborative effort by the European Federation of Financial Analysts Societies (EFFAS), the Federation of European Securities Exchanges (FESE) and the International Securities Market Association (ISMA), now the International Capital Market Association (ICMA). ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of exchanges, banks, trade associations and academics.

European capital markets have experienced rapid growth in recent years, corresponding to the gradual shift away from relationship banking as a source of funding and at the same time, have had to absorb and implement the massive output of EU-level regulation required to create a single market for financial services. These developments, combined with the immense challenges presented to European financial institutions by the globalisation of financial markets, highlight the importance of an independent entity to undertake and disseminate research on European capital markets.

The principal objective of ECMI is therefore to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

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