

# Credit Rating Agencies

## Scapegoat or free-riders?

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**Karel Lannoo**

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On the heels of similar action in the US, the EU now also intends to subject credit rating agencies to Europe-wide regulation. Notwithstanding his strong stated beliefs in market solutions and self-regulation, European Commissioner Charlie McCreevy issued a draft directive for consultation in July 2008, which proposes highly detailed and prescriptive regulation of the activities of rating agencies. Although policy-makers had no choice but to take the stick out from behind the door, the draft raises fundamental questions about the form of regulation, the impact on the industry and the markets. Alternatives should therefore be considered.

Rating agencies rapidly emerged as one of the first villains, but also victims of the financial crisis. Early after the outbreak of the subprime crisis in August 2007, it became evident that credit rating agencies (CRAs) had actively contributed to the real estate bubble by over-rating senior tranches in special purpose vehicles. Moreover, it also appeared that the CRAs faced serious conflict-of-interest problems because they not only rated the products, but also gave advice on how to structure them. Doubts had already emerged on the role of CRAs after the South-East Asia crisis in 1998 and successively in the dot-com bubble such that policy-makers could no longer stand aside. The general feeling now is that statutory regulation is required. Not only did the European Commission come to that conclusion, but also the Financial Stability Forum (FSF) in its report on the market turmoil (April 2008) and the European Parliament in two own initiative reports (Rasmussen and van der Burg, September 2008), which explicitly recommend further regulation.

Ratings agencies are special entities, however, and there are only a few that count. The two largest ones, S&P and Moody's, are said to control 80% of the global market in which there is limited competition. Their ratings play a quasi-formal role in financial markets, and are used by many players to determine their portfolio allocation. A downgrade by a rating agency has immediate and dramatic consequences for a firm, or even a country. Lehman's fate for example was sealed when its credit rating was cut to junk status on Friday, September 12<sup>th</sup>. Ratings are also used by supervisors to determine the risk weight of assets to calculate a bank's regulatory capital requirement, especially under the Basel II rules.

The underlying problem is quite simple: policy-makers and market participants need a reliable indication of the creditworthiness of borrowers (and the quality of certain assets). It would be impossible for every investor to make an in-depth investigation on his own of the creditworthiness of every potential borrower or any investment vehicle.

Karel Lannoo is Chief Executive Office at the Centre for European Policy Studies in Brussels. This commentary was previously published in *Intereconomics*, September/October 2008.

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Ratings agencies provide this information and thus provide huge savings in transaction costs. However, not many ratings agencies can exist, as transaction savings would disappear. In addition, if dozens of ratings agencies were active, market participants and policy-makers might find many ratings for each borrower and this would make it also difficult for borrowers to provide a clear signal to the market about their creditworthiness. Credit rating agencies thus essentially provide a public good, and the sector therefore cannot be expected to be fully competitive.

Policy-makers have been aware for some time of the problems posed by the special position of ratings agencies. Until a few months ago, it was assumed that the problem could be solved with the Code of Conduct developed by the International Organisation of Securities Commissions (IOSCO). However, the worsening of the financial turmoil in the first half of 2008 left European policy-makers little room for manoeuvre, and in June, Commissioner McCreevy formally called for statutory legislation of CRAs. In a speech at CEPS on July 3rd, McCreevy said: “the IOSCO Code of Conduct to which the rating agencies signed up has not produced its desired effects. I am not persuaded that the appropriate response lies in strengthening the voluntary framework established by the IOSCO code. International convergence is desirable, but on many issues, Europe must take the lead.” The US already acted in the sense that all rating agencies must obtain a formal licence from the Securities and Exchange Commission (SEC).

The Commission draft proposes that ratings agencies would receive formal authorisation within the EU, based upon the single market’s home country principle. On the basis of an authorisation in one member state, ratings agencies would be allowed to offer their services throughout the EU, or to establish branches. The draft recommends minimum governance and tight operational requirements, the identification and disclosure of conflicts of interest, rules for Chinese walls between analysts and sales people, and for the related compensation policies.

Nevertheless, the European Commission proposal raises fundamental questions:

- 1) Confronted with a globally concentrated industry, can the EU act alone?
- 2) Considering the fragmentation of the EU market, how will the regulation be applied?
- 3) Is functional regulation, as proposed by the European Commission, appropriate, or is more objective-based regulation needed?
- 4) What side effects may be caused by statutory regulation of CRAs?

Although the SEC also requests rating agencies to be registered, the EU draft proposal goes much further. In effect, the EU is taking the lead in detailed regulation of the sector, on the basis of “manifest failure of self-regulatory efforts”, i.e. the IOSCO Code. How the EU regulation will work at international level is not discussed. In light of the global nature of the industry and the international base of its users, CRAs may choose not to be active in the EU any longer, or reduce their presence, whereas European banks and listed firms would continue to call upon their services. The EU rule would in that case have only limited effect.

On the enforcement of rules within the EU, the Commission proposal exceeds what is possible in the current institutional setting. The Commission proposes a key role for CESR (Committee of European Securities Regulators) in the authorisation procedure, or the creation of a new Community Agency. In the former case, the Commission is asking a mere advisory Committee to decide on the designation of a home member state supervisory authority. This should ensure that the rating agency has its formal authorisation in the state where it has its most important activities. In addition, it is

proposed that CESR would exercise a coordination role in ensuring proper supervision across the EU. The McCreevy proposal stretches the mandate of CESR, with the risk that member states may simply ignore its decisions. On the other hand, creating a Community Agency for the supervision of CRAs seems excessive. This could be better addressed in the context of a broader re-design of the EU institutional setting of financial supervision in response to the financial crisis.

CRAs could be better regulated under the same umbrella as investment firms or analysts. Objective-based regulation, which sets principles by which such firms should abide, would allow newcomers to more easily enter the sector, which could be spin-offs from broker-dealers, for example. Such regulation already exists at EU level in the Markets in Financial Instruments Directive (MiFID), which regulates broker dealers, investment advisors and exchanges. It contains detailed rules on governance and operational requirements, and on the disclosure of conflicts of interest, which could, *ceteris paribus*, be applied to rating agencies as well.

Functional regulation for a sector that is as specific as rating agencies could lead to undesirable side effects. It has been argued that it further strengthens the quasi-statutory role of these bodies, which may reduce their alertness. It reinforces the barriers to entry, whereas the opposite should be done. And it could give rise to more litigation. CRAs already now face the problem that their ratings have a quasi-formal character. A licence would only reinforce this conception, eventually leading to more litigation.

Statutory regulation of the sector can be supported, but its design should be the subject of careful reflection. It should be more objective-based, with its 'touch' lighter than what is currently envisaged, and be subject to as much international coordination as circumstances allow.