Enhancing the regulation of credit rating agencies, in search of a method

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List of Abbreviations, acronyms and defined terms

ABS	Asset-backed securities
AFME	Association for Financial Markets in Europe
AIFM	Alternative Investment Fund Manager
BCBS	Basel Committee on Banking Supervision
BCOB	Basel Committee Oversight Body
BIS	Bank for International Settlements
BoE	Bank of England
CAD	Capital Adequacy Directive
CAR	Capital adequacy requirements
CARs	Capital adequacy ratios
CCC	Central Counterparty Clearing
CDO	Collateralised Debt Obligation
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CRAs	Credit Rating Agencies
CRAAC	Credit Rating Agency Assessment Centre
CRD	Capital Requirements Directive
EBA	European Banking Authority
EC	European Commission
ECAI	External Credit Assessment Institution
ECB	European Central Bank
ECGI	European Corporate Governance Institute
ECOFIN	Economic and Financial Affairs Council
ECON	Committee on Economic and Monetary Affairs
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ESAs	European Supervisory Authorities
ESFS	European System of Financial Supervisors
ESM	European Stabilization Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board

EU	European Union
FDIC	Federal Deposit Insurance Corporation
Fed	Federal Reserve System
FIs	Financial Institutions
FSA	Financial Services Authority
FSB	Financial Stability Board
FSC	Financial stability committee
FSCS	Financial Services Compensation Scheme
FSF	Financial Stability Forum
G-20	Group of Twenty Largest Developed Economies
G-SIFI	Globally Systematically Important Financial Institution
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAAP	Internal Capital Adequacy Assessment Process
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Rating Based
LCR	Liquidity Coverage Ratio
LOLR	Lender of Last Resort
LTCM	Long Term Capital Management
LTV	Loan to value, usually Loan to value ratio
MAD	Market Abuse Directive
MBS	Mortgage-backed security
NAISC	US National Association of Insurance Commissioners
NBER	National Bureau of Economic Research
NRSRO	Nationally Recognized Statistical Rating Organization
OECD	Organization for Economic Cooperation and Development
OtC	Over-the-Counter
OtT	Originate-to-Transfer
RACs	Rating agency confirmations
S&P’s	Standard & Poor’s
SEC	U.S. Securities and Exchange Commission
SIFI	Systematically Important Financial Institution

SIFMA	Securities Industry and Financial Markets Association
SIVs	Structured investment vehicles
SLS	Special Liquidity Scheme
SPV	Special Purpose Vehicle
SREP	Supervisory Review Process
SRR	Special Resolution Regime
TALF	Term Asset-Backed Securities Loan Facility
UCITs	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States

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Abstract

It is commonly considered that credit rating agencies play a key role in the securities markets because of their general perception as an arbiter of government debt. In fact, they have got too much power particularly after the wake of recent financial crisis. This research provides tentative proposals to reform the present normative regime of credit rating agencies. The analysis commences mapping the contours of the legal aspects of credit ratings services. Firstly, it addresses the major questions regarding the credit rating agencies *modus operandi*. Its relevance lies on the fact that credit ratings pressure the market confidence and influence both the investor decisions and market participants expectations. Secondly, it investigates whether ratings industry is defective in terms of information asymmetries, laxity in regulation, absence of transparency, conflicts of interest and limited competition and is likely to remain so even after the regulatory reforms introduced in the EU and the US have been implemented. For these reasons there is risk for a potential distortion or ‘market failure’ of the financial sector. In this context, the current scholarly debate about which liability system works best in the credit rating agencies governance is considered. Far from providing conclusive results, this research suggests that a system of credit rating agencies with a single supervisory authority and a stringent rules-based approach could be more effective in protecting investors, while producing tangible benefits for the securities market.

Key Words: Credit Rating Agencies, Securities Regulation, Compliance Function, Corporate Regulation.

JEL Classifications: K20, K22.

Chapter 1

Rise and Fall of the Credit Rating Agencies: Where Do We Stand and Where Are We Going?

1.1 Introduction

Nowadays, it is commonly considered that credit rating agencies ("CRAs") play a key position in the financial markets because of their general perception as an information intermediary between investors and issuers.

CRAs are private companies which provide public opinions as to the creditworthiness of financial products (bonds, loans and commercial paper) and are mainly financed by commission fees[1].

Ratings are based on issuers' public information and are taken into account in determining matters such as trends or financial policies. In fact, ratings estimate the risk in relative rank order, which is to say there are credit risks not predictive of a specific frequency of default or loss[2]. It has been observed that 'ratings are forward-looking statements which represent the raters' judgement of the creditworthiness of an entity'[3].

CRAs provide an assessment of the ability of issuers to meet their debt obligations through information monitoring services that promote liquid markets (investment grade)[4].

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[1] As defined by Section 3(a) (60) of the U.S. Credit Rating Agency Reform Act of 2006, credit rating means 'an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments'. In the words of Standard & Poor's, 'a credit rating is S&P's opinion of the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factor'. In Moody's words, a rating is 'an opinion on the future ability and legal obligation of an issuer to make timely payments of principal and interest on a specific fixed-income security'. See also Art. 3 of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (OJ 2009 L 302 p. 1): (a) 'credit rating' means an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories; (b) 'credit rating agency' means a legal person whose occupation includes the issuing of credit ratings on a professional basis.

[2] See Damien Fennel and Andrei Medvedev, 'An economic analysis of credit rating agency business models and ratings accuracy' (November 2011) *Financial Services Authority*, Occasional Paper Series No. 41, 9-10.

[3] See Arad Reisberg, 'The future role of credit rating agencies in contemporary financial markets – A theoretical perspective', in Dan Prentice and Arad Reisberg (eds), *Corporate Finance Law in the UK and EU* (OUP 2011) 173.

[4] See IMF, 'The Uses and Abuses of Sovereign Credit Ratings', in World Economic and

In academic circles, credit rating agencies are classed as 'certification intermediaries'[5] or 'reputational intermediaries'[6]. It can be said that CRAs are reputational intermediaries providing certification services to investors[7]. These services can consist in monitoring and assessing a company's creditworthiness.

CRAs provide two services: solicited ratings, where the issuer requests a rating for its securities in return for a fee, and unsolicited ratings, which are based only on publicly available information and no fee is paid.

The CRAs business model, whereby the rating agencies are paid by the self-same entities whose products they are rating, is often referred to as the 'pays-issuer' model. This regime was adopted by the main credit-rating agencies (Moody's, Standard & Poor's, Fitch IBCA, Duff and Phelps Credit Rating Co.) in the early 1970s. Consequently, the main credit-rating firms[8] changed their business models from the 'investor pays' model established by John Moody in 1909 to an 'issuer-pays' model. Indeed, it is noteworthy that the entities whose products are being rated are the parties who are actually paying for their products to be rated.

The credit agency is paid by the party wishing to be assessed but 'its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients'[9].

At the international level, IOSCO defines a credit rating as 'an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an

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Financial Surveys. Global Financial Stability Report. Sovereigns, Funding and Systemic Liquidity (October 2010) 88-89.

[5] For this view see Stephen Choi, 'Market Lessons for Gatekeepers' (1998) 92 *Northwestern University Law Review* 3, 924; see also Jonathan Macey, 'Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation' (1998) 65 *University of Chicago Law Review* 4, 1500.

[6] See Reiner H. Kraakman, 'Corporate Liability Strategies and the Costs of Legal Controls' (1984) 93 *Yale Law Journal* 5, 895-96; see also Reiner H. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2 *Journal of Law, Economics, and Organization* 1, 54. From this perspective, the credit rating agencies are repeat intermediaries who provide certification or verification services to investors. The issuer uses the reputational intermediary to send a credible signal that its securities are of above average quality in order that it can pay a below average interest rate. See on this point John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (OUP 2006) 288.

[7] In particular, the term defines a form of independent and external monitor displaying by someone who control or verify compliance with rules.

[8] The main CRAs nowadays are Moody's Investor Service, Standard & Poor's Ratings Services and Fitch Ratings.

[9] See John C. Coffee Jr., 'Understanding Enron: "It's About the Gatekeepers, Stupid" (2002) 57 *The Business Lawyer* 4, 1405. In particular, it is noted that the gatekeepers need to preserve their reputational capital for the long run slackened.

established and defined ranking system; they are not recommendations to purchase, sell, or hold any security'[10]. According to this definition, credit rating opinions do not constitute recommendations for investors but simply opinions or views evaluate the likelihood of timely repayment.

However, the exercise of freedom of expression carries with it duties and responsibilities[11]. These duties and responsibilities may be subject to such restrictions (liability for false and misleading misrepresentations or gross negligence) prescribed by law as are necessary for the prevention of market disorder[12].

So the question is whether a 'mere opinion' can be considered to carry with it an exemption from any responsibilities. On this assumption, CRAs cannot be held liable for losses arising from detrimental reliance on their ratings[13].

An issue that needs to be addressed is whether there is any scope for considering an opinion—on which investors and consumers have placed reliance—as carrying liability. In other words, whether CRAs can be liable for investors' losses on the basis of the fact that the investors relied on the ratings.

Recently, the District Court of New York held that 'ratings on notes sold privately to a select group of investors were not matters of public concern deserving of traditionally broad protection under the First Amendment of the U.S. Constitution'[14].

This ruling provides a new perspective on liability of CRAs because it holds that ratings of securities that were distributed to a limited number of investors do not deserve the same free-speech protection as more general

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[10] See IOSCO Technical Committee, 'Code of Conduct Fundamentals for Credit Rating Agencies' (December 2004) 3.

[11] In such case, it is necessary to draw a parallel with the law of defamation, where the right to freedom of expression has to be balanced against the right to one's reputation and family life (privacy). Defences under English law include justification (i.e. what you are saying is true) and freedom of speech may be the subject to certain privileges in the public interest. Otherwise, damages may be payable.

[12] See on this point Alex Barker, 'Brussels to unveil curbs on rating agencies' *Financial Times* (London, 14 November 2011).

[13] See on this point Gregory Husisian, 'What Standard of Care should govern the world's shortest editorials?: An analysis of Bond Rating Agency Liability' (1990) 75 *Cornell Law Review* 2, 454-55. The author argues that 'ratings are editorial opinions, published in letter form'.

[14] See *Abu Dhabi Commercial Bank v et al. v. Morgan Stanley & Co., et al*. [2009] District Court of New York, No 08-7508. This is the only case in which a US court has not held that agency ratings constitute protected commercial speech under the First Amendment.

ratings of corporate bonds that were widely disseminated[15].

But CRAs frequently argue that they are not party to any contractual relationship with the investors but only with issuers. As a result, the relationship is between the CRAs and the companies that request the security rating.

According to the existing literature, it is necessary to take account of CRAs civil liability regime. In particular, the scholarly debate about which liability system works best in the governance of CRAs will also be considered.

After providing a general introduction of CRAs features, the next section provides an overview of the ratings environment and describes the role of CRAs in the securities markets taking into account the importance of the main players and their dynamics.

1.2 Overview and Terms of Reference

Generally speaking, CRAs play the role of a driver of the securities market and are 'hardwired' into the regulatory system. In particular, credit ratings play a critical role for investors, who often have mandates that stipulate they can own only debt of a certain grade.

The recent financial crisis has witnessed an expansion of the CRAs' power worldwide and revealed not only market failure and regulatory failure, but also failure of the current legal regime for credit ratings.

Risk management failed to recognize the powerful function of ratings and their potential systemic effects on financial markets, because the financial crisis confirmed that there was an overdependence on CRAs[16].

Specifically, credit-rating agencies created a systemic risk because of the scant incentive for them to perform their screening accurately while policymakers, institutional investors and global regulators underestimated the functions and risks stemming from credit rating agencies. However, the financial institutions are now recognizing the magnitude of the systemic risks displayed by ratings in the banking and securities system.

In substance, investors in securities misunderstood the key role played by

[15] ibid 33. In particular, the Court has affirmed that 'where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the protection of the First Amendment'.

[16] See Amadou N.R. Sy, 'The Systemic Regulation of Credit Rating Agencies and Rated Markets' (2009) *IMF* Working Paper 129, 29.

credit ratings in the investment decisions of financial participants and the widespread use of 'ratings triggers' in private contracts[17]. But investors should be aware that the expansion of the CRAs' power could interfere with the sound functioning of the capital markets[18]. However, the power of rating agencies has more to do with moral suasion tools than with governmental authority because 'this informal power becomes formal only when politicians make it so; regulators naturally milk the agencies when things are going well and scapegoat them when things are bad'[19].

The securities market has also revealed that CRAs has led to tighter oversight of gatekeepers while also revealing the limits of regulators' power. For instance, buy-side firms such as pension funds, mutual funds and insurance companies have made huge use of ratings assessments in order to ensure compliance with statutory laws[20].

The ratings are involved in the regulatory standards of capital requirements (especially in the so-called pillar I 'Minimum Capital Requirements' of the Basel II Accord) and in setting capital models for credit risk[21]. In particular, CRAs play an important role in the capital adequacy regulation of banks and in the determination of regulatory capital through the 'standardised approach'[22].

[17] Rating triggers are contractual provisions that give counterparties and lenders the right to terminate the credit availability, accelerate credit obligations, or have the borrower post collateral, in the event of specified rating actions, such as if the rating of the borrower's fixed-income securities falls below a certain level. These provisions are sometimes required by counterparties in order to help them secure collateral and recover prospective losses in cases where a borrower faces a serious likelihood of bankruptcy or default. However, some rating triggers might have significant potential negative impact on the issuer. In fact, contractual rating triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. See on this matter CESR, 'CESR's technical advice to the European Commission on possible measures concerning credit rating agencies' (March 2005) 38-39 and 87-93. See also Christopher C. Nicholls, 'Public and Private Uses of Credit Ratings' (2005) *Capital Markets Institute Policy Series*, 16-20.

[18] See Shahien Nasiripour, 'Ratings agencies quizzed over MF Global' *Financial Times* (London, 29 January 2012).

[19] See Christopher Caldwell, 'An inconvenient truth: the power of moral suasion' *Financial Times* (London, 9 December 2011).

[20] See U.S. Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets. As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002* (January 2003) 28.

[21] See Howell E. Jackson, 'The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy', in Eilís Ferran and Charles A.E. Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001) 315-22. See also Rolf H. Weber and Aline Darbellay, 'The regulatory use of credit ratings in bank capital requirement regulations' (2008) 10 *Journal of Banking Regulation* 1, 4-5.

[22] See Deniz Coskun, 'Credit-rating agencies in the Basel II framework: why the standardised approach is inadequate for regulatory capital purposes' (2010) 25 *Journal of International Banking Law and Regulation* 4, 157-58. The author underlines that pillar I of the

Recently, the Basel III framework assessed measures to mitigate the reliance on external ratings of the Basel II regime. These measures include requirements for banks to perform their own internal assessments of externally rated securitisation exposures[23].

In this regard, it has been rightly observed that 'it seems paradoxical that the regulators, on the one hand, criticize credit rating agencies for their role in the financial crisis and subject them to regulatory control but, on the other hand, leave them the key to the financial markets'[24].

The increasing role of CRAs in the financial markets can be explained by the reputational incentives and regulatory license model[25]. The former works only if the intermediary has gained sufficient reputational capital to be trusted by investors[26], while the latter works by reducing the issuer's costs or the costs of financial intermediaries, allowing rating agencies to sell regulatory licenses to enable such persons to avoid these costs[27].

In this context, it has been observed that 'the rating agencies have evolved from information providers to purveyors of regulatory licenses'[28]. Specifically, securities regulation has increasingly relied on credit ratings and the credit rating agencies sector.

The regulators have used credit ratings (for instance to assess the sovereign debt of countries) by conferring on rating agencies some 'regulatory licenses'—the right to be in compliance with regulation[29].

Basel II provides the so-called "standardised approach" to credit risk measurement by recognising the credit ratings of external credit assessment institutions (ECAIs).

[23] See Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (June 2011) 4. In particular, these measures also include 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.

[24] See Jan Oster, 'Who Rates the Raters? The Regulation of Credit Rating Agencies in the EU' (2010) 17 *Maastricht Journal of European and Comparative Law* 4, 374.

[25] See Frank Partnoy, 'Barbarians at the gatekeepers?: a proposal for a modified strict liability regime' (2001) 79 *Washington University Law Quarterly* 2, 494. Professor Partnoy observes that 'a good reputation is valuable in transacting with other parties, and reputational capital enables parties to use trust to reduce the costs of transacting'.

[26] See on this view Douglas W. Diamond, 'Reputation Acquisition in Debt Markets' (1989) 97 *Journal of Political Economy* 4, 829-32.

[27] See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (n 6) 288. The author also observed that 'such sales of regulatory licenses need not be based on trust or reliance on the rating agency, but only on the short-term cost savings realizable'.

[28] See Frank Partnoy, 'Rethinking regulation of credit-rating agencies: an institutional investor perspective' (2010) 25 *Journal of International Banking Law and Regulation* 4, 188.

[29] See Reisberg, 'The future role of credit rating agencies in contemporary financial markets – A theoretical perspective' (n 3) 179.

In this setting, as a commentator has observed, 'regulatory licenses, and the behavioural overdependence on ratings that followed them, ultimately led to the creation and growth of the financial instruments at the core of the recent crisis'[30].

The benefits associated with these regulatory licenses stem from securities laws, self-regulatory principles and uncertain court decisions[31]. This scenario allows CRAs to circumvent the rules and avoid liability for misrepresentations or misconduct and most importantly monitoring of their assessment[32]. Ratings downgrading can trigger sales of certain financial products, underscoring the agencies' powerful role.

Such regulatory licenses allow CRAs to engage in ambiguous behaviour including omissions and misleading opinions (see, for instance, the Enron case)[33].

Consequently, investors use ratings to make decisions on the credit risk of fixed-income securities and financial regulators use credit ratings to increase the monitoring of the risk of investments held by regulated entities.

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[30] See Frank Partnoy, 'Historical Perspectives on the Financial Crisis: Ivar Kreuger, the Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets' (2009) 26 *Yale Journal on Regulation* 2, 442-43. In particular, the author implies that 'without financial innovation and overreliance on credit ratings, the recent crisis likely would not have occurred, and certainly would not have been as deep'.

[31] See Frank Partnoy, 'The Siskel and Ebert of Financial Markets?' Two Thumbs Down for the Credit Rating Agencies' (1999) 77 *Washington University Law Quarterly* 3, 623. The author argues that 'credit rating are valuable not because they contain valuable information, but because they grant issuers regulatory licenses; a good rating entitles the issuer (and the investor in a particular issue) to certain advantages related to regulation' (681). Professor Partnoy also observes that rating agencies sell information and survive based on their ability to accumulate and retain reputational capital. But once regulation is passed that incorporates ratings, rating agencies begin to sell not only information but also the valuable property rights associated with compliance with that regulation (682).

[32] See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (n 6) 288. Professor Coffee points out that 'the core idea behind the regulatory license is that regulation imposes costs which a favourable rating can reduce'. The author implies that 'a rating enables issuers to escape costly regulatory burdens or prohibitions to which they would otherwise be subject; or portfolio managers and institutional investors gain legal protection by virtue of such a credit-rating, because it insulates them from potential claims that they breached their fiduciary duties to investors in buying or holding the security'.

[33] See John C. Coffee Jr., 'What caused Enron? A capsule social and economic history of the 1990s' (2004) 89 *Cornell Law Review* 2, 287-97. It has been noted by Professor Coffee that the failure of the gatekeepers to detect Enron's collapse can be explained by the 'general deterrence' and 'bubble market' hypothesis. The first focuses 'on the decline in the expected liability costs that faced auditors who were considering whether or not to acquiesce in aggressive accounting policies favoured by managers'. The second focuses on the fact that—in an atmosphere of market euphoria—'gatekeepers have less relevance and, consequently, reduced leverage with their clients'. See also Deniz Coskun, 'Credit rating agencies in a post-Enron world: Congress revisits the NRSRO concept' (2008) 9 *Journal of Banking Regulation* 4, 266-69. The author argues that 'CRAs failed to exercise the due urgency and probing investigation, so as to signal and inform the capital markets of the impending implosion of Enron'.

But ratings are also used by regulators to determine when particular investment products can be sold to the public and as a diversification tool to manage institutional investment. This means that the market price is influenced by rating pronouncements and CRAs' opinions that can affect financial confidence.

In this regard, it has been argued that 'the success of debt-raising by an issuer depends on the rating of the debt, with the rating a prerequisite which determines the interest rate offered and the cost of capital'[34].

However, as intermediaries, credit ratings should profit from protecting investors because they manage 'market information', which is generally considered to be a public good[35].

In this light, ratings can be considered to be responsible of a public good because financial information is in nature of a public good. Consequently, CRAs are trusted fiduciaries and mainstays of the financial community. One commentator has stated that 'in bond ratings, the rating agencies are the key gatekeepers, in whom the trust of the investing public is reposed; public trust in any corporate gatekeeper is founded upon faith in its corporate governance apparatus'[36].

Confidence in the rating agencies to get it right has been shaken by a growing number of criticisms and controversies[37]. Also the integrity of the CRAs' activity is threatened by the demands of winning and retaining clients in the more lucrative consultancy business.

In this respect, the major questions regard the CRAs *modus operandi*. The relevance of this lies in the fact that credit ratings affect market confidence and influence investors' decisions and their expectations. For this reason it will be assumed that CRAs represent a potential distortion—in terms of market failure—for the securities industry.

In this way, the research aims to show the importance for CRAs for ensuring investors' protection. Consequently, the analysis will be based on the

[34] See Niamh Moloney, *EC Securities Regulation* (OUP 2008) 689.

[35] See Stephen Choi, 'A Framework for the Regulation of Securities Market Intermediaries' (2004) 1 *Berkeley Business Law Journal* 1, 48.

[36] See Franklin Strier, 'Rating the Raters: Conflicts of Interest in the Credit Rating Firms' (2008) 113 *Business and Society Review* 4, 539.

[37] See John Patrick Hunt, 'Credit rating agencies and the "worldwide credit crisis": the limits of reputation, the insufficiency of reform, and a proposal for improvement' (2009) *Columbia Business Law Review* 1, 112-14. See also Efraim Benmelech and Jennifer Dlugosz, 'The alchemy of CDO credit ratings' (2009) 56 *Journal of Monetary Economics* 5, 630-33.

assumption that CRAs should improve the incentives to supply complete available information and enhance clean competition. In other terms, CRAs should enhance financial stability considered as a public good for market participants.

It is plain that if a financial market is stable, everybody has the benefit and nobody can be deprived of it. However, as has dryly been observed, 'financial instability is driven by human myopia and imperfect rationality as well as by poor incentives, and because any financial system will mutate to create new risks in the face of any finite and permanent set of rules'[38].

In the light of these considerations, this research intends to explore the major issues concerning the internal governance of CRAs. It attempts to analyze how CRAs have developed, increased and influenced the expectations of financial participants. It is clear that CRAs help to build market confidence and investors' belief in financial products.

After examining the increasing role of CRAs in the securities sector and how they operate—with particular emphasis on certain drawbacks in the current regulatory framework—the following section provides an analysis of ratings main activities.

1.3 Setting the scene of credit rating agencies

It is worth noting that credit rating agencies play the role of financial gatekeepers by giving an evaluation of the creditworthiness of securities products while not being involved in conducting factual verification. This means that CRAs are entities established to measure the relative risk that a borrower will fail to meet its financial commitments (such as interest payments and repayment of principal on a timely basis)[39].

CRAs are intended to act as 'forecasters' with regard to the debt liability of the issuer and its probability of default. But accuracy of forecasting is the key question of credit rating[40]. This forecasting activity is currently regulated by a

[38] See Adair Turner, 'Reforming finance: are we being radical enough?', 2011 Clare Distinguished Lecture in Economics and Public Policy, Clare College (Cambridge, 18 February 2011) <http://www.fsa.gov.uk> accessed 23 January 2012.

[39] See IMF, 'Global Financial Stability Report' (n 4) 88.

[40] According to Coffee's view, 'the accuracy of a credit rating is only demonstrated over the long-run, but the payment for it is made in the short-run. This mismatch can create agency problems, as the managers who determine the rating may expect (or intend) to be around at the

composite system of best practices, guidelines and legal principles.

In order to ensure adequate protection for investors, a liability regime is needed. However, the gatekeeper's function highlights the question of what kind of liability should be attached to ratings.

It is interesting to observe that despite the criticism that has been expressed in various quarters on account of the effects of the recent downgrades, investors continue to choose the same main CRAs (Standard & Poor's, Moody's and Fitch). This aspect raises an important concern about the huge reliance of investors and the weakness of 'reputational incentive theory'[41]. Another question rises about the business model of CRAs, particularly the 'issuer-pay model' that incentives the risk of conflicts of interest[42].

CRAs' knowledge of the consequences of inaccurate prediction might be considered to be morally equivalent to knowingly publishing a misleading assessment. To eliminate or reduce this kind of risk there is need for investors to find rating agencies relevant only for genuine insight or for customised analysis.

This potential damage is inextricably connected with the problem of consumer protection and market confidence[43].

The credibility of CRAs' forecasting activity measures their reputation and provides a clear pattern to understand predictions. Issuers pay for an objective prediction while investors (or consumers) rely on an independent assessment. But the predictions are only very rarely subjected to empirical verification, and when such verification is attempted, some of the predictions are shown to be unreliable[44].

It is generally pointed out that the inaccuracy of rating is due to the

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end of the ratings cycle'. See John C. Coffee Jr., 'Ratings Reform: The Good, The Bad, and The Ugly' (2010) *ECGI*, Law Working Paper No. 145, 29.

[41] See Tom Hurst, 'The role of credit rating agencies in the current worldwide financial crisis' (2009) 30 *Company Lawyer* 2, 64.

[42] As already noted, rating agencies operate under an issuer-payment model under which issuers request agencies to provide ratings which are a prerequisite for external debt financing.

[43] In this context, market confidence means as that 'it is safe' for investors to participate in a certain financial market. The importance of market confidence is fundamental in order to design a rationale for the regulation of CRAs.

[44] See on this point Joshua D. Coval, Jakub W. Jurek and Erik Stafford, 'Economic Catastrophe Bonds' (2009) 99 *American Economic Review* 3, 628-29. The authors observe that 'credit ratings describe a security's expected payoffs in the form of its default likelihood and anticipated recovery value given default; however, because they contain no information about the state of the economy in which default occurs, they are insufficient for pricing'. See also Joshua D. Coval, Jakub W. Jurek and Erik Stafford, 'The Economics of Structured Finance' (2009) 23 *Journal of Economic Perspective* 1, 4-5.

existence of (1) conflicts of interest, (2) the lack of proper competition and, (3) reluctance to make disclosure[45]. These concerns could determine a 'market failure' if they are not adequately corrected by intervention on the part of the regulators.

The first aspect (i.e. conflicts of interest) can be explained as a species of strategic behaviour in the issuer-credit ratings relationship and clearly emerges in the mechanism of 'pay-issuer model'.

The issuer fees characterize the compensation system. Thus, the most common conflict of interest is in the revenue received by CRAs from the issuers that they rate. This scheme inevitably fosters an incentive to over-rate in order to secure a high fee and inflated ratings. At this stage, an internal compliance function could be introduced with a view to reducing the practice of going for high profits.

A possible solution of this question would rely on constraining rating fees. To resolve this problem, it is necessary to divorce issuer payment of the CRA from issuer selection of the CRA or encourage an alternative subscriber-pays market for ratings[46]. In other words, a system of standardized revenues could be put in place in order to reduce reliance on the 'issuer-pays' business model.

Therefore, an 'investor-paid model' (or subscriber-pays model) could be provided to resolve the question of conflicts of interest.

The second aspect (i.e. proper competition) can be better described by the fact that only three main CRAs (Standard & Poor's, Moody's and Fitch) operate in the whole financial markets. It is enough for one agency to become lax in its rating activity for this to have negative consequences on the prediction of default events. Most investors rely on these agencies, which makes for oligopoly and increases the inaccuracy of forecasting.

This issue is closely connected with the position of consumers (usually considered the weaker party to the transaction) because they are disadvantaged by the trading practices of suppliers[47]. In academic circles, a proposal has been

[45] It has been observed by Professor Choi that 'conflicts of interest and agency cost problems within securities intermediaries are examples of problems with potential market-based solutions'. See Stephen Choi, 'A Framework for the Regulation of Securities Market Intermediaries' (n 35) 72. In particular, the author stresses the efficacy of self-tailored regulation because it acts as a mechanism to reduce the anti-competitive effects that rely on reputational incentives.

[46] See John C. Coffee Jr., 'Ratings Reform: The Good, The Bad, and The Ugly' (n 40) 49.

[47] See Joanna Benjamin, *Financial Law* (OUP 2007) 563. The author argues that consumers are 'classes of person deemed to be economically weak'.

made that competition should be encouraging by enacting an 'equal access' rule under which issuers would be required to disclose their data publicly[48]. The equal access approach would ensure greater competition among the main CRAs and encourage smaller credit rating agencies to enter the U.S. Nationally Recognized Statistical Rating Organization (NRSRO).

However, clean competition restrains the prices that suppliers can charge and therefore their profits. It exerts pressure on them to reduce costs, thereby rendering enterprise productively more efficient. It also encourages them to respond to consumer expectations regarding quality.

The third aspect (i.e. reluctance to make disclosure) is connected with the 'appropriate' information disclosed by CRAs on their rating methodologies; this concern involves the risk of informational asymmetries between issuers and consumers.

It is generally considered that informational asymmetries—one of the most principal cause of 'market failure'—bring about an imbalance of information between parties to trade (one so severe that exchange is impeded) and that their effects justify regulatory intervention by the institutions.

In the economic literature, informational asymmetries represent a situation where the capital receivers are in the position of having more knowledge about the prospects and condition of the corporation than the capital suppliers, and are thus in a position to abuse the advantage[49]. There is market failure in enhancing rating quality owing to a lack of competition and hence effective reputational discipline for getting it wrong.

For instance, if there is competition between CRAs most of them will have an incentive to establish and maintain their reputation and that should enable both parties (agencies and issuers) to terminate the transaction at relatively low cost and, as a result, constrain the opportunistic possibilities for market failures created by informational asymmetries.

It is manifest that the party with superior information as to the prediction of the probability of default can opportunistically use it to induce the other party

[48] See John C. Coffee Jr., 'Ratings Reform: The Good, The Bad, and The Ugly' (n 40) 5.

[49] See Anthony Ogus, *Costs and Cautionary Tales. Economic Insights for the Law* (Hart Publishing 2006) 48. In particular, the author highlights that the better informed economic agents have a natural incentive to exploit their informational advantage. Regulation is generally introduced to correct the informational asymmetries, and is usually in the form of mandatory disclosure. Market participants have the capability and incentives to deploy mechanisms to prevent market failure caused by asymmetric information.

(issuer) into unexpected and undesired outcomes. But 'once the oligopolists' grip is pried loose, there will be no shortage of analysts ready to set up shop. Clients may hesitate to use unknown newcomers, but veterans of the big three should capture business'[50].

After providing an analysis of ratings activities, the next section provides a critical appraisal of the CRAs function taking into consideration the potential liability regime for credit rating agencies.

1.4 A critical appraisal of the CRAs function

CRAs have been accused of giving more weight to political rather than economic factors and getting their timing wrong (see, for example, the warnings of downgrading of members of the eurozone in the financial turmoil)[51]. Policy makers' reliance on credit ratings has increased in the current sovereign debt crisis (particularly during the Greek crisis in 2011-2012), where rating downgrades lead to market losses for countries together with adverse effects such as the rapid drying up of liquidity[52].

Credit ratings firms were criticized not only for issuing inaccurate ratings to mortgage-linked securities leading up to the financial crisis, but also for weaknesses in internal controls and procedures for managing conflicts of interest, including firm policies on securities trading[53].

Recent empirical studies have shown internal control weaknesses on corporate debt rating[54]. In this regard, a proposal has been made 'to establish an independent assessment institution to assess the accuracy of CRA estimates of probability of default, and to publish comparative studies of such accuracy'[55].

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[50] 'Redeeming ratings' *Financial Times* (London, 10 November 2011).

[51] 'S&P credit warning provokes outrage' *Financial Times* (London, 7 December 2011) 7.

[52] The current financial crisis has revealed the huge role played by credit rating agencies in the rapid growth of structured products markets. In fact, the structured products require a targeted rating that considerably involves the assessment process of credit agencies. This higher volume of highly rated securities was one of the causes of the crisis in that it fuelled the 'originate-to-distribute' model.

[53] See Kara Scannell, 'SEC critical of rating agency's controls' *Financial Times* (London, 30 September 2011).

[54] See Samir M. El-Gazzar, Kwang-Hyun Chung and Rudolph A. Jacob, 'Reporting of Internal Control Weaknesses and Debt Rating Changes' (2011) 17 *International Advances in Economic Research* 4, 421-25.

[55] See Charles A.E. Goodhart, 'How, if at all, should Credit Ratings Agencies (CRAs) be Regulated?' (June 2008) LSE Financial Markets Group Paper Series, Special Paper No. 181, 25-26. See also Charles A.E. Goodhart, *The Regulatory Response to the Financial Crisis* (EEP

Perhaps a separately established independent authority would be too costly for the financial industry and it would be less credible if it were to be directly controlled by the industry itself.

In the well-known corporate scandals (Enron, WorldCom, Lehman Brothers etc.), these companies were given high ratings and investors relied on it. For instance, Enron case illustrated this problem[56]. The CRAs then downgraded them but only after holding off for a time. It has been observed that 'this pattern in which a ratings downgrade resembles more an obituary than a prophecy again suggests the absence of real competition'[57].

Investors piled into these seemingly high-growth companies, the credit rating agencies downgraded their ratings, red-flagging them as increasingly high-risk, albeit not in danger of imminent collapse[58]. This concern was considered negative by market participants because ratings changes appeared to be sluggish, inaccurate and with few incentives to be responsive to investors[59].

CRAs have no incentives to screen the accuracy of their assessment methodologies[60]. This assumption stems from the recent performance with regard to the evaluation of financial sector creditworthiness. Such considerations can justify the evident delays of CRAs review in the recent corporate failures (Enron, WorldCom, Lehman Brothers etc.). The point is that rating agencies should establish a direct relationship with investors.

These corporate scandals underlined the need for improving the working of

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2009) 129. In particular, the author suggests the establishment of a small independent body (a CRA Assessment Centre).

[56] See Jeffrey N. Gordon, 'What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections' (2002) 69 *University of Chicago Law Review* 3, 1234-35. See also John C. Coffee Jr., 'Understanding Enron: "It's About the Gatekeepers, Stupid" (n 9) 1409-12.

[57] See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (n 6) 285. The author observes that 'rationally, the nominal competitors may prefer to enjoy the quiet life and not invest in the personnel or monitoring necessary to detect financial decline before it becomes public knowledge'.

[58] See Andrew Hill, 'Enron: see no evil, hear no evil, speak no evil' *Financial Times* (London, 2 December 2011) 19. In particular, the author observes that 'when the rating agencies downgraded Enron's debt to junk in late November 2001 (they had been holding off in the hope a rival group might buy the energy trader; many Wall Street analysts still rated the company a "buy" or "strong buy"), it was bust within days'.

[59] See William H. Beaver, Catherine Shakespeare and Mark T. Soliman, 'Differential Properties in the Ratings of Certified vs. Non-Certified Bond Rating Agencies' (2006) 42 *Journal of Accounting and Economics* 3, 310-12.

[60] See John C. Coffee Jr., Enhancing Investor Protection and The Regulation of Securities Markets' (2009) Columbia Law and Economics, Working Paper No. 348, 66-67. The author implies that 'credit rating agencies face little liability and perform little verification; the only force that can feasibly induce them to conduct or obtain verification is the threat of securities law liability'.

CRAs. They also drew attention to the fallibility of the CRAs' assessment, on which investors typically rely for protection[61]. For instance, in the Enron failure, gatekeepers certified the issuer's compliance with an inventory of highly technical rules—without the auditor necessarily taking responsibility for the overall accuracy of the issuer's statement of its financial position[62]. In this regard, it has been argued that 'the gatekeeper's services have value only if the gatekeeper is certifying compliance with a meaningful substantive standard'[63].

In addition, these corporate collapses raised questions about the conflict of interests of the CRAs that perform consultancy work for their clients[64].

In this regard, the securities industry has not settled the question as to whether CRAs should be liable for misrepresentations or fraud to issuers and investors.

The government initiatives (at the European and US level) have only attempted to improve transparency and fairness of CRAs by creating a challenging system of regulation and supervision that enables the rating industry to deliver services considered indispensable but, as far as possible, prevents them from pursuing activities that are deemed detrimental to consumers.

The legal system set in place by the global regulators (IOSCO, FSB, G-20 and SIFMA) failed to create a proper normative framework for CRAs. This 'light touch' regime revealed weaknesses in addressing enforcement concerns.

Therefore, another crucial question is the scarce enforceability of the self-regulation regime governing the CRAs (in respect to principles, recommendations and codes of conduct delivered by global regulators).

It is self-evident that more extensive regulatory reform of CRAs is needed in order to restore investors' and markets' confidence in ratings. The regulation of CRAs must be focused on conduct, certainty and soundness—it set out from a consumer perspective rather than an industry perspective.

Rating agencies are like the gatekeepers of the capital markets, so it is very

[61] Ibid 10-15. Professor Coffee argues that two factors represent persuasive explanations for gatekeeper deterioration: (1) the rise of structured finance and the change in relationships that it produced between the rating agencies and their clients; and, (2) the appearance of serious competition within the ratings industry that challenged the long stable duopoly of Moody's and Standard & Poor's and that appears to have resulted in ratings inflation.

[62] See John C. Coffee Jr., 'Understanding Enron: "It's About the Gatekeepers, Stupid" (n 9) 1416.

[63] ibid 1417.

[64] See on this point Stephanie Kirchgaessner and Kevin Sieff, 'Moody's chief admits failure over crisis' *Financial Times* (London, 24 April 2010).

important to look for an appropriate regulatory response to these issues. However there is still hesitation on the part of some regulators to introduce formal regulation and demand formal controls over the CRAs[65].

As indicated earlier, ratings were under fire because of their inaccuracy in evaluating companies' creditworthiness on account of the fact that the CRAs earned profits by selling regulatory licenses to issuers[66].

Paradoxically, these profits did not reflect the informational value of the ratings. The problem was that the main CRAs have become more profitable even as the quality of their ratings has collapsed.

From this perspective, it has been argued that 'regulatory dependence on ratings created higher demand for ratings and increasingly higher profits for NRSROs, even when their ratings proved spectacularly inaccurate'[67].

For that reason legitimate concerns have been raised about the regulatory reliance on ratings because they increase the incentives to shop for ratings.

In this context, it can be noted that the reliability of CRAs is principally motivated by the experience and reputation of rating agencies among investors. In fact, the gatekeeper is trusted to the extent that it is a repeat player who possesses significant reputational capital and information that would be lost or depreciated if it were found to have been involved in misconduct. Thus, the ratings market looks like an oligopoly with few high profitable agencies that earn a consistently high rate of return.

This sort of oligopolistic market was increased by the US Nationally Recognized Statistical Ratings Organization and the SEC policy of entitling only selected rating agencies to assess issuers' bonds. But the oligopolistic position of the big CRAs 'seems attributable instead to the high barriers to entry into this market, which require that a new firm acquire reputational capital before it can acquire clients'[68]. On this point, it has also been observed that 'this lack of competition permits these nominal competitors to shirk, engaging in less effort and research than if there were true active

[65] See Gilian Tett, Jennifer Hughes and Aline Van Duyn, 'S&P unveils ratings overhaul' *Financial Times* (London, 7 February 2008).

[66] See John Gapper, 'Let rating agencies have their say' *Financial Times* (London, 8 December 2011) 11. In particular, it is observed that 'the agencies remain a protected species because central banks use ratings from officially approved agencies for purposes including deciding which collateral to take from banks and assessing the riskiness of assets'.

[67] See Frank Partnoy, 'Rethinking regulation of credit-rating agencies: an institutional investor perspective' (n 28) 190.

[68] See John C. Coffee Jr., 'Ratings Reform: The Good, The Bad, and The Ugly' (n 40) 55.

competition'[69].

In this regard, the reputational capital of CRAs has constituted a wire fence with respect of investors and regulators creating a huge gap in the information supply process. The credibility of CRAs has progressively taken the place of regulatory interventions of financial institutions[70].

As already indicated, the structure of securities regulation favours the involvement of CRAs by way of unmonitored actions. As a result, the lack of a proper liability regime facilitates misstatements and negligence.

These considerations underline the question whether rating agencies should be subject to a system of civil liability[71].

In the scholarly debate, a model has been proposed which combines the better incentives of strict liability with a system that: (1) places a realistic ceiling on the gatekeeper's aggregate liability; and, (2) minimizes the transaction costs associated with enforcement[72]. This proposal subordinates compensation to deterrence, but only with regard to litigation against gatekeepers, who are seldom in any event in a position to fund full compensation to the class of investors and consumers[73].

A valuable suggestion has been made that strict liability could be imposed on gatekeepers, such as CRAs, for material misstatements and omissions in offering documents while removing any due diligence-based defences from securities regulation[74].

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[69] See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (n 6) 285.

[70] See Mathias Audit, 'Aspects internationaux de la responsabilité des agences de notation' (2011) 100 *Revue critique de droit international privè* 3, 582-85.

[71] It may seem surprising because the rating agencies enjoy a virtual immunity from private litigation. The recent cases have shown a reluctance to impose civil liability on CRAs. See, in particular, *Jefferson County Sch. Dist. v. Moody's Investor services, Inc.* [1999], No 97-1157; *Compuware Corp. v. Moody's Investor services, Inc.* [2007] No 05-1851; and *Newby v. Enron Corporation* [2005] 511 F. Supp. 2d 741.

[72] See John C. Coffee Jr., 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', in Guido Ferrarini, Klaus J Hopt, Jaap Winter and Eddy Wymeersch (eds), *Reforming Company and Takeover Law in Europe* (OUP 2004) 459. The author observes that strict liability coupled with a ceiling can produce adequate deterrence without necessarily exceeding the boundaries of political feasibility.

[73] See on this matter Frank Partnoy, 'Strict Liability for Gatekeepers: A Reply to Professor Coffee' (2003) University of San Diego School of Law, *Law and Economics Research Paper*, 3.

[74] See Frank Partnoy, 'Barbarians at the gatekeepers?: a proposal for a modified strict liability regime' (n 25) 540. In particular, the author argues that 'gatekeepers benefit from valuable property rights created by securities regulation, which generates both regulatory costs and regulatory licenses' (546). According to Partnoy's proposal, a gatekeeper is strictly liable for a percentage of the securities fraud damages that the issuer pays. Professor Partnoy also observes that 'the ex post costs of litigating securities disputes against gatekeepers would be almost entirely eliminated'.

According to Partnoy's view, the advantage of imposing strict liability on gatekeepers would be that it would incentivise transparency and fairness[75]. However, such solution would not afford a solution in terms of responsibility to investors (i.e. customers). A strict liability regime would be effective only with respect to the issuer, leaving the question of losses incurred by the investor unresolved. In addition, strict liability could be potentially costly for inducing gatekeepers to thwart client misconduct[76].

According to Coffee's view, 'the gatekeeper could be held liable even when the issuer is not'[77]. In particular, this proposal assumes that the gatekeeper failed its responsibility to discover the irregularity and should not be absolved because the issuer's conduct was only negligent, rather than fraudulent.

Central to Coffee's position is the 'adverse selection' problem. This means that 'if gatekeepers cannot distinguish ex ante the "honest" from the "dishonest" issuer, a lemons market developed under strict liability should logically drive the honest client from the market'[78].

Therefore, a strict liability regime is justified only if it can address the CRA-investor relationship. Such a liability regime may go a long way to remedy perceived negligence and poor services[79]. This type of liability system may contribute to preserve CRAs' reputational capital. But without specific legislation introducing such liability, it is hard to see how a case could be brought against rating agencies for liability.

In order to design an adequate liability system the optimal strategy could be to induce and empower gatekeepers to insist upon compliance with the law. Specifically, the ratings assessment could be better regulated both through

[75] ibid 542.

[76] See Assaf Hamdani, 'Gatekeeper liability' (2003) 77 *Southern California Law Review* 1, 60. The author argues that 'holding gatekeepers strictly liable will not guarantee that clients enter the market only when it is socially desirable to do so'. Precisely, if strict liability is not superior in inducing gatekeepers to police client conduct, there is no justification for favouring it over other forms of liability (84). According to Hamdani's view, gatekeeper liability determines an inevitable trade-off between preventing misconduct and minimizing the disruption of market access. In these terms, no regime of gatekeeper liability is likely to produce the first-best outcome. This underscores the limited usefulness of gatekeeper liability as an instrument of social policy aimed at preventing misconduct (106).

[77] See John C. Coffee Jr., 'Partnoy's complaint: a response' (2004) 84 *Boston University Law Review* 2, 377-82. Professor Coffee argues that 'imposing strict liability without some ceiling on the potential damages will not galvanize gatekeepers into resistance, but also the corporate clients who will bear the higher fees that come with strict liability' (382).

[78] ibid 380.

[79] See Tom Hurst, 'The role of credit rating agencies in the current worldwide financial crisis' (n 41) 61-64. See also Mia Mahmudur Rahim, 'Credit rating agencies' roles have to be reassessed' (2010) 4 *Law and Financial Markets Review* 4, 435.

internal controls and hard-law measures[80].

This research will seek to demonstrate that a mixed regime that includes elements of both strict liability and compliance activities could be a favourable regime for credit rating agencies[81]. Such mixed liability regime may improve the credibility (i.e. reputation) of CRAs implementing policing measures such as monitoring, investigating, and reporting misconduct.

In this regard, the establishment of an internal control mechanism for the ratings procedures could encourage companies to operate under market incentives such as transparency and fairness. In particular, on-going compliance programs may solve the monitoring problems (for instance, when agents cannot verify the firm's monitoring ex ante)[82]. This type of regulatory approach should increase the governance of the CRAs and their legal duties to avoid and interdict the offences[83].

After examining the rating agencies deficiencies in the recent corporate collapses and their inaccuracy in evaluating companies' creditworthiness, the next section provides a plan of the research.

1.5 Plan of the research

This research will be structured as follow. In the second chapter, the focus will be on an analysis of CRAs internal governance. The investigation will be conducted having regard to the observable differences in the rating agencies' characteristics and through the probable development of regulation. The features of each major rating agency will be examined in order to identify its

[80] As just noted, in the banking and financial services industry this role is particularly significant. The global economic crisis created a wave of legislation designed to mitigate risk and protect the financial system from shocks. See Paul Taylor, 'How to make ready for regulation' *Financial Times* (London, 9 November 2011).

[81] This analysis intends to extend the proposal argued by Arlen and Kraakman. See Jennifer Arlen and Reiner H. Kraakman, 'Controlling corporate misconduct: an analysis of corporate liability regime' (1997) 72 *New York University Law Review* 4, 691-94. The authors suggest—in a corporate governance environment—a mixed entity liability regime that combines aspects of strict liability together with duty-based liability. In substance, this regime includes (1) modified forms of strict liability that are adjusted to induce firms to adopt policing measures; and, (2) "composite" liability regimes that combine monitoring and reporting duties with a residual element of strict liability to induce preventive measures and regulate activity levels.

[82] ibid 766-67.

[83] The concept of gatekeepers' duties raises again the question of gatekeepers' liability. In fact, it has been observed that 'its enforcement potential depends not only on the offense and the level of culpability that triggers personal liability, but also on the choice of gatekeepers and upon the design of their duties'. See, on this point, Reiner H. Kraakman, 'Corporate Liability Strategies and the Costs of Legal Controls' (n 6) 892.

strengths and weaknesses with a view to defining an efficient regulatory scheme relating to internal structure, *modus operandi* and asset management.

The results will be interpreted on the base of rating activity, measuring positive and negative effects of adopted regulation. In order to test compliance with rules, sample supervision models will be utilized for the rating agencies. This analysis should provide significant implications with regard to the applicable normative framework.

The evidence should elicit material for further research into aspects such as (1) the motivation of CRAs to issue solicited or unsolicited ratings; (2) the discretion of CRAs to bring into play evaluation models and to control the treatment of information; and, (3) the assessment of rating agencies' responsibility.

In the chapter three, an investigation of CRAs regulatory reforms will be carried out, together with appraisals of best practice. It will consider how harmonized rules could eliminate differential treatment under the law and introduce on-going supervision with accountable responsibility for rating agencies. However, methods for securing more cooperation among global regulators, with a system of integrated controls, will also be considered. Such rules could require the disclosure of all aspects of the ratings activity, with the emphasis on the evaluation methods and enhancing the transparency of information.

The original contribution is to arrange such a regulatory framework in such a way as to make CRAs accountable, while proposing concrete solutions to the problems of information asymmetries and conflicts of interest as between issuers and investors. Voluntary principles (i.e. guidelines, standards, principles) would be merely secondary: hard law rather than soft law. An outcomes-based regime (i.e. rules-based regime) rather than a principles-based regime would prevail.

The idea is that CRAs should be made responsible for their investment certification because of their fundamental role in the evaluation of credit risk and influencing investors' confidence.

After briefly outlining the structure of this research, the next chapter focuses on the regulation of CRAs internal governance. It draws attention to the importance of understanding the dynamics of the interrelationships between rating agencies and investors. Also, it assesses the scrutinising and validating role played by CRAs through their assessment methodologies.

Chapter 2

The Regulation of CRAs Governance

2.1 Background and regulatory features

Standard & Poor's stated that 'credit ratings are designed primarily to be our forward-looking opinions about creditworthiness and unlike other types of opinions, such as, for example, those provided by doctors or lawyers, credit ratings opinions are not intended to be a prognosis or recommendation'[84]. On this view, CRAs are primarily intended to provide investors and market participants with information about the relative credit risk of issuers and individual debt issues that the agency rates.

CRAs are not intended to measure a security's potential for price appreciation. They collect dispersed information on the financial situation of borrowers and the default risk of certain financial products, and condense it into a single measure of relative credit risk[85]. In other words, the key function of credit agencies is to assess the quality of credit of a company issuing a liability or the quality of a specific liability issue. Credit ratings play a public and social value in the financial market because of their reputational capital.

Despite this (apparent) normal purpose, governments and global regulators have become reliant on credit ratings. In particular, regulators have woven these agencies into everything from allowable investment alternatives for institutional investors to required capital for most global banking firms. Concerns about the CRAs' activity have worried investors from the beginning of financial crisis, when it started to stress market confidence.

The usefulness of a rating agency is dependent upon its reliability in making predictions and public acceptability. These two elements reflect the fact that market participants use the ratings of leading CRAs because the market trusts their ratings and participants know that other players will also

[84] See Standard & Poor's, 'Guide to Credit Rating Essentials. What are credit ratings and how do they work?' (2011) <www.standardandpoors.com> accessed 1 March 2012, 3.

[85] See Andreas Kruck, *Private Ratings, Public Regulations. Credit Rating Agencies and Global Financial Governance* (Palgrave Macmillan 2011) 1.

accept their evaluation. It is important that financial markets place trust in the CRAs' activity and the relevant processes that lead up to a rating evaluation. For instance, a low rating can drive up an issuer's borrowing costs or even put it out of business.

Credit agencies have played a long and established function in capital markets, providing investors with an assessment of the relative probability of default of security bonds. In this regard, 'credit rating agencies and their output play a unique, indeed important, role in overcoming the information asymmetries that are endemic to the capital market'[86].

This worthy function has changed into a sophisticated and complex technique for measuring financial soundness. The regulatory background of credit ratings began by approving the use of certain CRAs as Nationally Recognized Statistical Rating Organizations (NRSRO), a special designation body with functions of authorization, registration and control of rating agencies[87].

NRSRO status was conferred upon a select few agencies; it is important given that obtaining of a favourable rating has definitively become a *de facto* prerequisite for any company seeking to access the US financial markets.

Before 1970s, credit ratings were regulated under the Securities Act of 1933 (Rules 134 and 436), the Securities Exchange of 1934 (Section 17-H and Rule 10b-6), the Investment Company Act of 1940 (Rules 2a-7, 3a-7 and 10f-3) and insurance regulations (the National Association of Insurance Commissioners Securities Valuation Office).

The growth of credit rating agencies industry took place in the early nineteen hundreds when the investment banks started to require evaluations of

[86] See on this view, Herwig M. Langohr and Patricia T. Langohr, *The Rating Agencies and their Credit Ratings. What They Are, How They Work and Why They Are Relevant* (Wiley & Sons 2008) x.

[87] In the 1930s the first regulator to take notice of credit ratings was the Federal Reserve System which implemented a scheme for evaluating a bank's entire portfolio based on the credit ratings on the bonds in that portfolio. Subsequently, the United States Treasury Department introduced credit ratings as the valuable measure of the quality of a national bank's bond portfolio. In 1973, the SEC adopted Rule 15c3-1 (the 'net capital' rule) to incorporate credit ratings, but only those ratings promulgated by what it defined as 'Nationally Recognized Statistical Ratings Organizations'. Rule 15c3-1 was the first securities rule to recognize the validity of credit ratings. In fact, this rule required a different haircut for securities based on credit ratings assigned by NRSROs. However, Rule 15c3-1 created heavy barriers to entry for new rating agencies in the United States because it gave preferential treatment to bonds rated investment-grade by at least NRSROs. In substance, Rule 15c3-1 strongly encouraged broker-dealers to invest in rated bonds, increasing the ratings' market power.

their issues and because of the presence of economies of scale associated with spreading credit information[88]. Rating agencies developed from market surveillance mechanisms, particularly with the burgeoning of financial information[89].

The bond rating services increased in the early 1930s with the Glass-Steagall Act of 1933 and rise of securities businesses in the United States. The focus of bond rating activity was railroads, corporations and financial institutions, and pension funds and banking investments incorporated rating standards into their rules.

In a further development, the Securities and Exchange Commission and other regulatory institutions enacted normative tools to regulate the rating process. From mid-1970s credit rating agencies switched from their ‘subscriber business model’ to an ‘issuer pays model’, determining a substantial change in the core activity of these agencies. Indeed, with the ‘issuer-pays’ model, credit agencies solved the “free-rider question” of the supply of a public good in the investors’ community (the public availability of ratings manuals).

Ratings have been incorporated into government regulation and regulatory tools, but this policy trend exacerbated the competitive barriers as between rating agencies with negative effects. The use of ratings in public regulation demonstrated that the rating industry is more than a financial phenomenon.

These regulatory licenses have entitled credit ratings to gain and generate reputational capital among market participants. This sort of reputational capital is usually based on trust and credibility. Reputational capital represents an essential element of credit rating activity for two main reasons, namely the decision-making process and assessment accuracy. In these terms, reputation capital is a fundamental component of rating business model because it makes for confidence and investor protection.

The value of rating agencies depends on the quality of the information supplied to the market. Each rating agency depends for its livelihood on its credibility for independence and accurateness. In particular, credit ratings

[88] The first credit rating agency was founded by John Moody in 1909 (rating system for railroad bonds) after the establishment of mercantile credit agencies and debt manual publishers. In the early 1900s, the bond ratings agencies drew their revenue exclusively from subscribers. From the mid-1970s until today the revenue system turned into the ‘pay-issuer’ business model.

[89] See Henry V. Poor’s, *History of the Railroads and Canals of the United States of America* (New York, John H. Schultz, 1860); see also Henry V. Poor’s, *Manual of the Railroad of the United States, for 1868-69* (New York, H.V. & H.W. Poor, 1868).

operate through their valuable 'opinions' making public information on the credit risks of borrowers. But opinions have varying effect: 'the impact of a self-proclaimed messiah on a soap-box at Speaker's Corner may differ from the impact of a newspaper that prejudges a suspect as being guilty in a murder case'[90].

Investors rely on ratings evaluations about the likelihood of receiving timely payments on bonds. The rating certification of a bond quality has developed into a pre-requisite of the debt issue's credit value. Rating agencies capitalise on their reputational capital, thereby obtaining huge market power over investors, while exploiting the information asymmetry between issuers and investors.

However, there is a link between the certification activity and the signalling purpose of ratings. This combination has enhanced public confidence and, according to the reputational capital view[91], caused CRAs to become dominant intermediaries without any regulatory intervention.

'Credit rating agencies exist in a competitive market of information providers and live or die based on their reputational capital; credit ratings reduce information costs and therefore reduce issuers' cost of capital'[92]. The reputational capital view considers that credit ratings are important parts of credit information and therefore constitute good proxies for changes in the credit quality of the underlying bond.

Credit agencies increased their degree of trustworthiness by publishing rating manuals and analysis[93]. This rating system was based on subscription fees paid by investors. The symbols of the principal rating agencies (Fitch, Moody, Standard & Poor's, Duff & Phelps) were synthesized in letter and number scales. The letter 'A' or the number 1 to the highest grade, while the letter 'D' to the lowest grade.

The scales were ordinal such as 'A', 'B', 'C' and cardinal such as 'Aaa', 'Aa', 'A'. The higher the rating, the less risk of default on repayment to the creditor. It is important to bear in mind that rating is a source of information for investment decisions. Investors use ratings to reduce the risks of credit loss.

[90] See Andrew Fight, *The Ratings Game* (Wiley & Sons 2001) 3.

[91] See John C. Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (OUP 2006) 287-88.

[92] See Frank Partnoy, 'The Siskel and Ebert of Financial Markets?' Two Thumbs Down for the Credit Rating Agencies' (n 31) 635.

[93] See the volume *Analysis of Railroad Investments* published by Moody in 1909.

Once issued, rating agencies maintain scrutiny over issuers and their securities and investors are warned when changes affect issuers and financial products.

The reputational capital view helps to understand whether the raters' activities do not reflect the correctness of rating analysis but instead the amount of expertise and authority the agencies possess. It has been argued that 'market and government actors take account of rating agencies not because the agencies are right but because they are thought to be an authoritative source of judgments, thereby making the agencies key organizations controlling access to capital markets'[94].

However, the reputational capital theory does not explain why CRAs have enormously increased their action and power during the recent decades. According to Professor Partnoy, the inconsistency of the reputational capital view may be explained by three concerns: (1) inaccuracies in credit spread estimation, (2) increases in ratings-driven transactions, and (3) the growth of credit derivatives[95].

In a similar vein, 'the reputational capital view is contradicted by the notion that there were systematic inefficiencies in the non-investment-grade bond market allowing the owner of a diversified portfolio of corporate high-yield bonds to outperform, on a risk-adjusted basis, other fixed income investments'[96].

Generally, rating agencies have good reason to avoid inaccuracy because of their reputational capital. But a central feature in the current rating system is regulators' overreliance on wide market acceptance of a rating assessment. CRAs can influence, through 'downgrades', the capacity of borrowers to obtain funds.

The rise of credit agencies could be explained by the development of structured finance, the spread of complex financial instruments (such as credit derivatives, asset-backed securities, financial guarantees, arbitrage vehicles).

In economic terms, the credit spread represents the market's estimate of the riskiness of the bond compared to its risk-free counterpart, based on both the

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[94] See Timothy J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness* (Cornell University Press 2005) 2. In particular, the author argues that 'rating agencies, acting as embedded knowledge networks, can be thought to adjust the "ground rules" inside international capital markets, thereby shaping the internal organization and behaviour of institutions seeking funds' (15).

[95] See Frank Partnoy, 'The Siskel and Ebert of Financial Markets?' Two Thumbs Down for the Credit Rating Agencies' (n 31) 654.

[96] ibid. 663.

probability of default and the expected recovery in the event of default. Put another way, credit spread is the difference between the yield on the bond and the yield on a risk-free bond of comparable structure and maturity. It also represents one of the most important measures of credit risk[97]. The credit spread is a reflection of all available information in the market, including the rating.

Credit rating should reflect the estimation of credit spread, but the evidence does not support the conclusion that ratings reflect valuable and accurate information[98]. Therefore, rating change announcements provide no new information to the capital markets[99].

The rating market is a sort of oligopoly in which only big agencies operate. This aspect favours the possibility of that the agencies' activity is only lightly regulated. The credibility of credit ratings stems not only from their trustworthiness, but also from the protection granted by regulators.

The most important factor is limited competition among rating agencies. This factor allows accumulating reputational capital and incorporating market power over investors. It means that credit ratings control the available information and sell it under oligopolistic conditions.

But if the information sold does not reflect the credit spreads, rating agencies sell other values such as the right to reduce regulatory costs or the right to entry in the securities market with a valuable rating.

Regulatory protection confers credibility and reputational capital on credit ratings. This allows skipping rules and supervision because of regulatory permission to incorporate the rights of providing valuable certification. Such protection has eliminated the incentive to maintain quality ratings.

There are plenty of reasons to believe that credit ratings activity was changed by regulators for regulatory purposes. Global regulators have altered the nature of the CRAs' core business from that of 'informational intermediary' to that 'regulatory intermediary'. Issuers have started to pay rating fees not only to purchase credibility with the investor but also (and in

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[97] Another measure of credit risk is the Option Adjusted Spread (OAS), in which is accounted the riskiness of a bond compared to its risk-free counterpart.

[98] In recent years, several cases of corporate default have demonstrated the inaccuracy of credit ratings: for instance, the well-known Lehman Brothers, WorldCom and Enron cases of the early 2000s, but also investment banks and insurance companies.

[99] See Lee Macdonald Wakeman, 'The real function of Bond Rating Agencies', in Clifford W. Smith Jr. (ed.), *The Modern Theory of Corporate Finance* (2nd edn, McGraw-Hill 1990) 411.

particular) to purchase a license from the regulators.

It can be said that the regulators have the interest to maintain this regulatory *status quo* because of CRAs-dependent regulation (NRSROs represent an important part of the regulatory process and a crucial determinant of investment strategies).

Arguably, credit ratings act as an instrument for regulatory purposes. This characteristic is proved by the fact that CRAs are so powerful, despite their inaccuracy to supply valuable information. The ratings authority is demonstrated by every-time statements of issuers creditworthiness followed by investment grade assessment. Due to the status granted by government legislation and global regulators, credit rating agencies act as profitable arbiters of the financial markets.

In sum, the development of credit ratings shows that 'the important point is not what rating you have, but whether or not you have a rating'[100]. In other words, issuers utilize the rating "as a mirror for larks" to attract investors and market participants.

After providing an overview of the historical and normative background of credit rating agencies, the next section considers the gatekeeper function of CRAs taking into account the characteristics of ratings services and their relevance in the securities market.

2.2 The solicited and unsolicited ratings

The increasing role of the rating industry in the financial sector has attracted much attention particularly on account of the private and public purposes of CRAs. The involvement of ratings in the global institutions underlines the fact that 'the use of raters activities by national and international regulatory bodies constitutes a form of delegation of governance tasks and (quasi-) regulatory authority from public to private actors'[101].

Credit ratings can be categorized in the following main types namely: (1)

[100] ibid 410.

[101] See Andreas Kruck, *Private Ratings, Public Regulations. Credit Rating Agencies and Global Financial Governance* (n 85) 5. The author argues that 'the use of private credit ratings by public national and international regulators constitutes a complex institutional mode of publicly sanctioned and publicly bolstered private governance of financial markets'.

short-[102], (2) medium-[103] and (3) long-term credit ratings[104]. They can also be classified as (i) default ratings (assessment the default risk of an issuer), (ii) recovery ratings (measure of the expected recovery rate when default has occurred)[105], (iii) credit conversion factor ratings (provide an ordinal opinion on the exposures prospects) and (iv) expected loss ratings (measure of the average losses occurred due to default in a portfolio). Also, mention should be made of the practice of split ratings that occur when two rating agencies—typically Moody's and S&P's—assign a different rating to the same security[106].

However, there are other forms of ratings such as (1) local[107] and foreign currency ratings[108], (2) national scale ratings (denote the quality of the issuer/issue relative to others within a specific home market), (3) stand-alone ratings (reflect the issuer's financial strength and creditworthiness without any intervention from the state, shareholders or stakeholders), (4) claims payability and deposit ratings (provide a view on the ability of an insurance organization to fulfil its insurance policies and contracts under the agreed terms), (5) municipal ratings (express an opinion on the investment quality of US municipal and tax-exempt issuers and issues), (6) support ratings (indicate a judgement of a potential supporter's propensity and ability to support a bank facing difficulties), (7) country and country ceiling ratings (represent a country's relative credit risk and serve as an important guideline for foreign

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[102] A short-term issuer or obligation rating is based, in all cases, on the short-term vulnerability to default of the rated entity or security stream and relates to the capacity to meet financial obligations in accordance with the documentation governing the relevant obligation. Short-term ratings are assigned to obligations whose initial maturity is viewed as "short term" based on market convention. Generally, short-term ratings are concerned with the coming year. See Fitch, 'Definitions of Ratings and Other Forms of Opinion' (December 2011) <www.fitchratings.com> accessed 6 March 2012, 18.

[103] Typically, it considers longer time periods. Long-term credit rating is designed to evaluate the up-to-one-year expiration obligations.

[104] See Fitch, 'Definitions of Ratings and Other Forms of Opinion' (n 102). In particular, ratings of structured finance, project finance and public finance obligations on the long-term scale, including the financial obligations of sovereigns, consider the obligations' relative vulnerability to default. Ratings of individual securities or financial obligations of a corporate issuer address relative vulnerability to default on an ordinal scale.

[105] ibid 7. The 'recovery rating' scale is based upon the expected relative recovery characteristics of an obligation upon the curing of a default, emergence from insolvency, bankruptcy or following a liquidation or termination of the obligor or its associated collateral.

[106] See H. Kent Baker and Sattar A. Mansi, 'Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors' (2002) 29 *Journal of Business Finance & Accounting* 9-10, 1379.

[107] Broadly, a local currency rating evaluates an obligor's capability of generating sufficient local currency in order to meet its domestic currency financial obligations. See Tony Van Gestel and Bart Baesens, *Credit Risk Management* (OUP 2009) 137.

[108] ibid 137. In general terms, a foreign currency rating evaluates an obligor's ability to service foreign debt commitments taking into account the access to foreign exchange.

investments and final decisions).

Ratings can be assigned under a quantitative (based on quantitative information only) or a qualitative approach (characterized by a process of human expert analysis). Usually, CRAs set their ratings on the basis of both quantitative and qualitative assessments of the borrowing issuer's condition and the special provisions of the particular security at hand.

In the case of the first service, ratings are directly requested and paid for by the issuer of the rated product. This system is based on the close issuer-credit rating relationship because of confidential participation by the issuer in the ratings process.

Ratings use non-public information to assess the financial product. Non-public information can include credit agreements, acquisition agreements, private placement memoranda, and business projections and forecasts.

Non-public information is often provided pursuant to a confidentiality agreement between the rating agency and the issuer, or is provided premised upon the rating agency's policy to keep such information confidential[109]. However, in this type of rating services authors contend that there is a deep and persistent conflict of interests between issuers and raters which results in information asymmetries to the disbenefit of investors[110].

Solicited ratings characterize the 'issuer-pays' business model in which credit agencies are directly paid by their principals (companies, investment banks etc.). In this situation, potential conflicts of interest arise because of possible collusive actions in the agencies' relationship. Since the rating fee is paid by the principal, the issuer may be able to influence the rating obtained by threatening to use another agency or none at all if the rating assigned by the agency is too low[111].

In conducting their analysis, agencies may obtain information from issuers that might not otherwise be available to the public and factor this information into their ratings opinion. In this business model, managers and raters are often involved in the ratings process and participate in fees discussions.

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[109] See SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets. As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002' (January 2003), 26.

[110] See Timothy E. Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (2009) 59 *Case Western Law Review* 2, 246-47.

[111] See George G. Kaufman, 'The financial turmoil of 2007-20XX: causes, culprits and consequences', in John Raymond Labrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds), *Financial Crisis Management and Bank Resolution* (Informa London 2009) 4.

Such a model has the potential for conflicts of interest since the entities are paying for the rating.

But solicited ratings are subject to other concerns relating to ‘shopping for raters’ and the quality of the disclosed information. These concerns are related to the strategic behaviour of principal and agent. In the case of ‘rating shopping’ issuers move from one rating agency to another until they get a favourable rating. It has been claimed that ‘rating agencies that give out lower ratings risk their ratings not being selected and thus losing revenue to their less honest peers’[112].

Big companies might shop for the highest ratings on their lucrative issuance deals, including playing one rating agency against another when informally consulting them on structures to achieve high ratings[113]. However, the real question at stake is when CRAs and issuers find themselves in a situation of jointly applying a rating that CRAs, at bottom, believe is too high.

This means lack of competition, huge barriers for new entrants, higher conflicts of interest and low transparency. In the case of a new CRA a single fee-paying issuer may comprise a large portion of the CRA’s overall revenue, creating a potential conflict of interest that may influence its rating decisions should the new entrant fear a loss of this business[114].

The ‘issuer-pays’ model can reduce CRAs’ reputational capital because of serious perplexity about the objectivity of the rating process. This kind of discretion may influence the ratings process through biased assessment.

The second service, unsolicited ratings (i.e. ratings that credit rating agencies conduct without being formally engaged to do so by the issuer), is based on public rated activity in which CRAs are not paid by issuer and conduct their assessment using publicly available information about the financial product.

Some rating agencies (particularly S&P’s and Fitch) prefer to use the term

[112] See Lynn Bai, ‘On regulating conflicts of interest in the credit rating industry’ (2010) 13 *Journal of Legislation and Public Policy* 2, 263.

[113] See Nicolette Kost de Sevres and Lorenzo Sasso, ‘The new European financial markets legal framework: a real improvement? An analysis of financial law and governance in European capital markets from a micro- and macro-economic perspective’ (2012) 7 *Capital Markets Law Journal* 1, 50.

[114] See IOSCO Technical Committee, ‘Report on the activities of credit rating agencies’ (September 2003) 14.

'shadow'[115] or 'pi'[116] rating for ratings that are largely based on public information. In the words of S&P's, 'unsolicited ratings are those credit ratings assigned at the initiative of Standard & Poor's and not at the request of the issuer or its agents'[117].

This type of rating is the subject of some controversy in the literature[118], although it would seem clear that unsolicited ratings influence the markets and do at least reflect the level of public disclosure of the firms rated. The major questions regard the opacity of the rating process behind an unsolicited rating (in the absence of issuer input) and unclear access to public information.

Public information reviewed in the ratings process typically includes filings such as news reports, industry reports, bond and stock price trends and data from central banks.

Rating agencies may issue unsolicited ratings in order to force issuers to pay for ratings that they did not request[119]. Also, unsolicited ratings are used as a way of establishing a track record before breaking into a new market[120].

Unsolicited ratings have been described as simplistic and opportunistic activities. In particular, 'rating agencies have been accused of running an operation akin to a classic protection racket in summarily issuing unsolicited ratings to various entities that are perceived as vulnerable to paying rating fees'[121].

Empirical evidence has shown that unsolicited ratings tend to be lower than solicited ratings because of self-selection among issuers and the strategic conservatism of rating agencies[122].

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[115] According to Fitch, the 'shadow individual rating' emulates as far as possible in the circumstances the full 'due diligence' individual rating.

[116] According to S&P's, a rating with a 'pi' subscript is based solely on the analysis of an issuer's public information.

[117] See Standard & Poor's, 'Standard & Poor's Ratings Definitions' (24 February 2012) <http://www.standardandpoors.com/ratings/articles/en/eu/?articleType=HTML&assetID=1245329361492> accessed 28 February 2012.

[118] See Soku Byoun and Yoon S. Shin, 'Unsolicited Credit Ratings: Theory and Empirical Analysis' (2002) Working Paper, Financial Management Association Annual Meeting <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354125> accessed 23 February 2012, 3-5.

[119] See Lynn Bai, 'On regulating conflicts of interest in the credit rating industry' (n 112) 264. The Author observes that this happened in the leading case of *Jefferson County School Dist. No. R-1 v. Moody's Investor's Services, Inc*.

[120] ibid 264-65.

[121] See Andrew Fight, *The Ratings Game* (n 90) 2.

[122] See Christina E. Bannier, Patrick Behr and Andre Güttler, 'Rating Opaque Borrowers: Why Are Unsolicited Ratings Lower?' (2010) 14 *Review of Finance* 2, 263-66. The authors suggest that 'lower unsolicited ratings could simply be caused by a self-selection of high quality companies into the solicited rating status and of low-quality firms into the unsolicited (or no) rating status'.

Specifically, when issuing unsolicited ratings, credit rating agencies tend to assign lower ratings than when hired and paid to do so. This may happen because there is no direct cooperation between issuers and raters and because of the incomplete (or low quality) information in the hands of the ratings agencies. 'Firms that receive unsolicited ratings may feel obliged to request and pay for a solicited rating if they believe the unsolicited rating is too low and that its credit reputation has been tarnished'[123].

In contrast, some commentators argue that unsolicited ratings provide a powerful check against rating shopping and can affect the yield paid at issuance[124]. Other scholars observe that unsolicited ratings are biased downward in contrast to solicited ratings. This difference in ratings comes from the significant self-selection bias (unsolicited ratings are still lower than solicited ratings after controlling differences in sovereign risk and key financial characteristics)[125].

In this context, valuable research has demonstrated that public disclosure not only appears to have a positive effect on credit ratings, but it also seems to eliminate the downward bias of unsolicited ratings[126]. Such research considers that unsolicited ratings are lower to "punish" issuers who otherwise would not purchase ratings coverage or unsolicited ratings are lower because they are based only on public information and, as a result, tend to be more conservative than solicited ratings[127].

Further empirical studies find that there is a significant difference in the distributions of ratings because banks that received shadow ratings are smaller and have weaker financial profiles than banks that have other ratings[128].

Another question is whether unsolicited ratings are used to increase the market share and extract payment from an unwilling issuer. CRAs tend to force companies to purchase their services with the purpose of making a profit. In

[123] See Abby Schultz, 'Wake-up Call for the Rating Agencies' (1991) 57 *The Investment Dealers Digest*, 18.

[124] See Richard Cantor and Frank Packer, 'The Credit Rating Industry' (1994) 19 *Federal Reserve Bank of New York Quarterly Review* 2, 5.

[125] For this view, see Winnie P.H. Poon, 'Are unsolicited credit ratings biased downward?' (2003) 27 *Journal of Banking & Finance* 4, 613.

[126] See Patrick Van Roy, 'Is there a difference between solicited and unsolicited bank ratings and if so, why?' (2006) National Bank of Belgium, *Working Papers Research Series* <http://www.nbb.be> accessed 29 February 2012, 25.

[127] ibid 2.

[128] See Winnie P.H. Poon and Michael Firth, 'Are Unsolicited Credit Ratings Lower? International Evidence From Bank Ratings' (2005) 32 *Journal of Business Finance & Accounting* 9-10, 1768.

addition, 'an unsolicited rating is 'feared' because it might put an issuer's credit risk in a worse light than it actually is with the justification that it only reflects publicly available information'[129].

By making unsolicited ratings CRAs operate as unfair and anticompetitive market participant because of speculative actions and abusive practices[130]. Unsolicited ratings may discourage new entrants from trying to build up a niche position because CRAs have traditionally been able to take advantage of economies of scale in ways that may inhibit entry for smaller competitors[131].

The IOSCO Code of Conduct stated that 'for each rating, the CRA should disclose whether the issuer participated in the rating process; each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings'[132].

Also, IOSCO CRA Principle ("Transparency and timeliness of ratings disclosure") affirms that 'CRAs should make disclosure and transparency an objective of their ratings activities'[133]. This principle intends to promote the distribution of sufficient information regarding ratings procedures and methodologies because there is risk of investor confusion in the issuance of unsolicited ratings.

Consumer confusion raises when ratings do not merely represent additional valuable information about the financial products but lead to investor uncertainty and force companies to purchase their services[134].

For instance, Moody's Investors Service has issued a set of policy statements regarding the right to issue unsolicited credit ratings in order to improve greater transparency to market participants[135].

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[129] See Fabian Dittrich, 'The Credit Rating Industry: Competition and Regulation' (2007) <http://ssrn.com/abstract=991821> accessed 28 February 2012, 110.

[130] See Elisabetta Cervone, 'Regulating Credit Rating Agencies in a Transatlantic Dialogue' (2008) 19 *European Business Law Review* 5, 838.

[131] See Pragyan Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth, 'Whither the credit ratings industry?' Bank of England, Financial Stability Paper No. 9 - March 2011, 7.

[132] See IOSCO Technical Committee, 'Code of Conduct Fundamentals for Credit Rating Agencies' (December 2004) 9; see also the revised version of May 2008.

[133] See IOSCO Technical Committee, 'Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Final Report' (February 2011) 30-31.

[134] See Francis A. Bottini Jr, 'An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies' (1993) 30 *San Diego Law Review* 3, 600.

[135] See Moody's Investors Service, 'Policy for Designating Unsolicited Credit Ratings in the European Union' (9 September 2011) 1.

The consequences of unsolicited ratings are important because of increasing market share and low accuracy. This suggests that there should be a clear intervention of public regulation in order to reduce the practice of ambiguous unrequested ratings. For (unpaid) unsolicited ratings, the requirement to internally rotate staff would need to be maintained to ensure independence for this type of ratings.

At the European level, the recent proposal for a CRA Regulation recommends that existing disclosure requirements for solicited and unsolicited ratings should be strengthened by requiring CRAs to inform issuers for which they are in the process of issuing a rating sufficiently in advance of the publication of the rating[136]. It could include a requirement to elaborate on the main assumptions which justify the change of rating and would apply both to solicited and unsolicited ratings.

In conclusion, the significant increase over time of references to credit ratings in rules and regulations—combined with scarce competition—has affected the business model of CRAs by creating a more or less "guaranteed market" with few incentives to compete on the basis of rating quality[137].

After providing an overview of the ratings services, the following section examines the critical elements of rating methodologies taking into account the controversial aspects of ratings criteria.

2.3 A focus on the rating methodologies

It is generally considered that rating methodology refers to the methods, and processes that govern CRAs' application of criteria to a particular rating or

[136] See European Commission, Impact Assessment. Accompanying the document. Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies and a Proposal for a Directive amending Directive 2009/65/EC on coordination on laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers (15 November 2011) *Commission Staff Working Paper*, 180 (OJ 2011 L 174 p. 1).

See also Regulation No 446/2012 of 21 March 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards on the content and format of ratings data periodic reporting to be submitted to the European Securities and Markets Authority by credit rating agencies (OJ 2012 L 140 p. 2) and Regulation No 448/2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority (OJ 2012 L 140 p. 17).

[137] See IMF, 'The Uses and Abuses of Sovereign Credit Ratings' (n 4) 94.

practice (i.e. corporate, public finance, asset-backed securities)[138].

Rating methodology is designed to measure the creditworthiness (or likelihood of default) of an issuer or an obligation. But beyond the likelihood of default other important factors are: (1) the payment priority of an obligation following default; (2) the projected recovery that an investor would expect to receive if an obligation defaults; and, (3) credit stability.

Rating systems represent a validation process consisting of a formal set of activities, instruments and procedures aimed at ensuring that the design of a model is conceptually sound[139].

Therefore, credit rating is a result of a credit rating process. A credit rating process involves a subjective assessment of both qualitative and quantitative factors of a financial instrument. This process begins with an application to the rating agencies by the issuer.

Credit ratings are dependent on ratings criteria, analyst and committee views, and surveillance processes, which can vary over time and across ratings systems.

Standard & Poor's has affirmed that 'creditworthiness is complex and while there is no formula for combining the different factors into an overall assessment, the criteria provide a guide in considering these factors'. The key objective is rank ordering the relative creditworthiness of issuers and obligations[140].

When assigning and monitoring ratings, CRAs consider whether they believe an issuer or security has a high likelihood of experiencing unusually large adverse changes in credit quality under conditions of moderate stress[141].

Rating methodologies are detailed processes for applying criteria to develop a rating. An example would be the specific quantitative measures that CRAs use to assess current and future cash flows and the ability to cover expected interest expense for issuers in specific industry sectors[142].

For instance, the sovereign rating methodology addresses the factors that

[138] See Standard & Poor's, 'Guide to Credit Ratings Criteria. Why criteria are important and how they are applied' (2010) <www.standardandpoors.com> accessed 1 March 2012, 3.

[139] See Luisa Izzi, Gianluca Oricchio and Laura Vitale, *Basel III Credit Rating Systems. An Applied Guide to Quantitative and Qualitative Models* (Palgrave Macmillan 2012) 114.

[140] See Standard & Poor's, 'Understanding Standard & Poor's Rating Definitions' (2010) <www.standardandpoors.com/ratingsdirect> accessed 5 March 2012, 6.

[141] See Standard & Poor's, 'Methodology: Credit Stability Criteria' (2011) <www.standardandpoors.com/ratingsdirect> accessed 5 March 2012, 2.

[142] See Standard & Poor's, 'Guide to Credit Ratings Criteria. Why criteria are important and how they are applied' (n 84) 3.

affect a sovereign government's willingness and ability to service its debt on time and in full. CRAs determine sovereign ratings based on a range of quantitative and qualitative factors with which they gauge a country's ability and willingness to repay its debt[143].

As just indicated, credit ratings are expressed in the form of a letter grades combination—a credit rating agency's assessment of the relative likelihood that there will be a credit default. The rating grades correspond to the CRA's criteria even if the exact combinations of letters and modifiers used by the single agencies differ. Each agency applies its own methodology in measuring creditworthiness and uses a specific rating scale to publish its ratings opinions. Ratings are expressed as letter grades that range from 'AAA' to 'D' to communicate the agency's opinion of relative level of credit risk.

There are three types of credit rating 'scales': (1) the fundamental ordinal scale which is used by CRAs to position the creditworthiness of an issuer or instrument; (2) financial market credit spreads, which result from the investment decisions of bond investors; (3) and market-implied credit ratings, which are derived from a combination of mathematical modelling of the arbitrage equilibrium prices of an issuer's equity and assets, probability theories and empirical observations of past defaults[144].

The CRA's 'criteria' are a significant part of the rating outcome because they identify the specific factors that agencies consider during the rating and surveillance processes.

Fitch ratings under its process reports seek continuously to improve its ratings criteria and methodologies, and periodically update the descriptions on its web site of its criteria and methodologies for securities of a given type.

Rating criteria reports describe the methodology used in assigning ratings (they contain clear, concise descriptions of the minimum rating factors in ratings of particular debt instruments or entities)[145]. Fitch explains that the criteria and methodology used to determine a rating action are those in effect at

[143] See Ashok Vir Bhatia, 'Sovereign Credit Ratings Methodology: An Evaluation' (2002) *International Monetary Fund*, Working Paper No. 02/170, 4-6.

[144] See Herwig M. Langohr and Patricia T. Langohr, *The Rating Agencies and their Credit Ratings. What They Are, How They Work and Why They Are Relevant* (n 86) 43.

[145] See Fitch Ratings, 'Managing and Developing Criteria and Models' (30 September 2011) <www.fitchratings.com> accessed 1 March 2012, 1. Specifically, 'criteria reports' describe Fitch's analytical methodology when assigning its rating opinions. The most significant rating factors will be identified and typically number three to six. These factors will be the main focus of the criteria report. In particular, experienced analysts assess and explain Fitch's rating criteria in specific areas of their expertise at the direction of senior managers.

the time the rating action is taken, which is the date of the related rating action commentary[146].

Rating methodologies and criteria can be subjected to some form of objective validation based on historical experience.

CRA's methodologies regard country-specific risks, industry and economic data, historical and projected financial statements, history of defaults, management policies, and features of the specific financial product.

In forming their opinions of credit risk, rating agencies typically use primarily analysts or mathematical models, or a combination of the two. S&P's claims that in the case of 'model driven ratings' a small number of credit rating agencies focus almost exclusively on quantitative data, which they incorporate into a mathematical model[147]. An agency using this approach to assess the creditworthiness of a bank or other financial institution might evaluate that entity's asset quality, funding, and profitability based primarily on data from the institution's public financial statements and regulatory filings.

Credit ratings express risk in relative rank order, which is to say they are ordinal measures of credit risk and are not predictive of a specific frequency of default or loss. Elaborating credit analysis, CRAs use the terms "investment grade" and "speculative grade" to describe the categories 'AAA' to 'BBB' (investment grade) and 'BB' to 'D' (speculative grade).

In the words of S&P's, the term "investment grade" historically referred to bonds and other debt securities that bank regulators and market participants viewed as suitable investments for financial institutions. The term is broadly used to describe issuers and issues with relatively high levels of creditworthiness and credit quality.

In addition, the term "non-investment grade" or "speculative grade" generally refers to debt securities where the issuer currently has the ability to repay but faces significant uncertainties, such as adverse business or financial circumstances that could affect credit risk[148].

[146] See Fitch Ratings, 'Code of Conduct' (22 November 2011) <www.fitchratings.com> accessed 1 March 2012, 11-12. In particular, at paragraph 2.3.3 is stated that 'where the rating is based, to a significant extent, on more than one methodology or where a review of only the principal methodology might cause financial market professionals to overlook other important aspects of the rating, Fitch shall indicate where the different methodologies and other important aspects, as the case may be, that were factored into the rating decision can be found'.

[147] See Standard & Poor's, 'Guide to Credit Rating Essentials. What are credit ratings and how do they work?' (n 84) 7.

[148] ibid 11.

Therefore, the terms "investment grade" and "speculative grade" are used as market conventions. Investment grade categories indicate relatively low to moderate credit risk, while ratings in the "speculative" categories either signal a higher level of credit risk or that a default has already occurred[149].

As discussed earlier, rating methodology represents the important part of the rating process because of its impact on the credit quality of financial products (the cost of issuing debt). However, to ensure integrity of ratings outcome an internal organization that revises and updates the criteria assumed needs to be developed.

The rating process often incorporates information about background data, forecasts, risk reports, or factual feedback on proposed analytical research and other communications.

At the start of the rating process, each rated entity or transaction is assigned to a primary analyst, who works with the support of a secondary analyst. Ratings are assigned and reviewed using a committee process. Primary analysts incorporate the information from their research into their rating recommendation and supporting committee package[150]. Key analytical factors are discussed in the rating report, while the credit analyst provides a recommendation for credit rating to a rating committee.

Rating decisions are based on a simple majority vote by the committee and represent the CRA's opinion as to the likelihood that the issuer will repay its financial obligations. By voting, the committee assigns the rating, for which it takes collective responsibility[151]. The rating process is characterised by rating outlooks that indicate the potential direction of a rating over the intermediate term and rating reviews that give a stronger indication of future rate changes[152].

In the case of collateralised debt obligations ratings, assets rated by the rating agency are counted at face value, while assets rated by a different rating agency are typically notched down. Continuous surveillance is provided by rating analysts in order to ensure that rated notes are performing within the initial parameters and assumptions[153].

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[149] See Fitch, 'Definitions of Ratings and Other Forms of Opinion' (n 102) 6.

[150] See Fitch Ratings, 'The Ratings Process', Special Report (2 December 2011) 3.

[151] See Herwig M. Langohr and Patricia T. Langohr, *The Rating Agencies and their Credit Ratings. What They Are, How They Work and Why They Are Relevant* (n 86) 170.

[152] ibid. 176-77.

[153] See John M. Griffin and Dragon Yongjun Tang, 'Did Credit Rating Agencies Make Unbiased Assumptions on CDOs?' (2011) 101 *American Economic Review* 3, 126.

It is possible to observe that credit rating is an overall financial statement in the form of an opinion delivered at the end of an internal process conducted by rating analysts and highly skilled professionals. However, no formal training, educational certificate, legal background, or degree qualification is required to be appointed as rating analysts.

Their statements have legal implications for the financial markets as a whole. As has been observed by a commentator, 'rating analysts do not have any formal qualifications, they do not sign off on statements, and they do not have a legal responsibility to stand behind the opinions they proffer'[154].

The different methods and approaches of rating raise questions about the real independence of rating agencies and the objectivity of rating assessment. CRAs use financial statements, information about the issuer, industry and market level factors. But the exact factors and related weights of these factors utilized in determining a credit rating are not publicly disclosed by the rating agencies.

CRAs contact the issuer's management before starting the analysis of financial products. Involvement of the issuer in the rating analysis, particularly in the agency's meeting could reveal potential collusive behaviour between the issuer and the rating committee. Internal ratings are based on economic and mathematical models that provide a score or rating range and this is used to determine the final internal rating as decided by a committee of experts[155].

Overriding the mathematical rating is subject to written internal rules and policies to ensure the objectivity of the internal rating. The difficult is to determine the accuracy of these models because of the subjectivity of the credit rating process. Rating lifetime, terminology and qualifiers represent an important part of rating process because they provide additional information about the specific meaning of the rating.

In terms of rating lifetime, a rating is called new when it is assigned for the first time to an issuer. Then, the rating is reviewed on a regular basis and is downgraded or upgraded when it has been lowered or raised in the scale. A rating can be removed for any reason that involve the credit agency and it can be stopped when the issue is paid in full, when the issue reaches maturity and

[154] See Andrew Fight, *The Ratings Game* (n 90) 4. The author observes that 'rating analysts work for companies that put out opinions with disclaimers denying all responsibility for the accuracy contained within'.

[155] See Tony Van Gestel and Bart Baesens, *Credit Risk Management* (n 107) 117-18.

when the issue is called 'early' or 'refinanced'[156].

In terms of rating terminology, different benchmarks are considered: (1) 'AAA', extremely strong capacity to meet financial commitments (the highest rating); (2) 'AA', very strong capacity to meet financial commitments; (3) 'A', strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances; (4) 'BBB', adequate capacity to meet financial commitments, but more subject to adverse economic conditions; (5) 'BBB-', considered lowest investment grade by market participants; (6) 'BB+', considered highest speculative grade by market participants; (7) 'BB', less vulnerable in the near-term but faces major ongoing uncertainties in the light of adverse business, financial and economic conditions; (8) 'B', more vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments; (9) 'CCC', currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments; (10) 'CC', currently highly vulnerable; (11) 'C', a bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued; (12) 'D', payments default on financial commitments[157].

In terms of rating qualifiers, there are different definitions: (i) ratings based only on published financial information ("pi" ratings); (ii) ratings based on a statistical rating model that is fed with ratios and variables derived from the financial statements ("q" ratings); (iii) ratings based on the likelihood of repayment of the principal portion of the obligation only ("p" ratings); (iv) ratings based on the likelihood of repayment of the interest ("i" ratings); (v) provisional ratings based on the credit quality assuming that the rated project is successfully completed ("pr" ratings); (vi) ratings based on the termination structures that are designed to honour their contracts at maturity or before ("t" ratings); (vii) ratings based on a shadow opinion or conditional rating that are not intended for publication ("*" ratings)[158].

Rating methodologies use the terms "point-in-time" and "through-the-cycle". More precisely, "point-in-time" systems attempt to produce ratings that are responsive to changes in current business conditions while "through-the-

[156] ibid 118-19.

[157] See Standard & Poor's, 'Guide to Credit Rating Essentials. What are credit ratings and how do they work?' (2011) 10.

[158] See Tony Van Gestel and Bart Baesens, *Credit Risk Management* (n 107) 119-20.

cycle" systems attempt to produce ordinal rankings of obligors that tend not to change over the business cycle. Also, "point-in-time" systems tend to focus on the current conditions of an obligor while "through-the-cycle" systems tend to focus on an obligor's likely performance at the trough of a business cycle or during adverse business conditions[159].

A "point-in-time" rating system uses all currently available obligor-specific and aggregate information to assign obligors to risk brackets. For its part, a "through-the-cycle" rating system uses static and dynamic obligor characteristics but tends not to adjust ratings in response to changes in macroeconomic conditions. It should be noted that CRAs have recently started to develop new methodologies that shift the criteria from a "through-the-cycle" to a "through-a-crisis" focus[160].

Consequently, banks are now taken in account in judgemental or qualitative models much closer to the "through-the-cycle" model. Rating quality and consistency are monitored by *ex post* instruments such as individual and global benchmarking, back testing and qualitative 'post-mortem' tools[161].

Significant studies have shown that 'analysis of a stylised model of rating systems indicates that the default probability assigned to each obligor rating grade and its dynamics strongly depends on the type of rating methodology and quantifycation techniques employed'[162]. Other commentators have attempted to demonstrate the validity of the different measures of structured finance ratings performance namely 'default or impairment studies' and 'ratings transition analysis'[163].

For CRAs, the key element in credit risk models is the measure of the 'probability of default', but exposure is also determined by the expected timing

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[159] See Basel Committee on Banking Supervision, 'Studies on the Validation of Internal Rating Systems' (2005) Working Papers No. 14, 14.

[160] In comparison with the "through-the-cycle" rating approach, this new stability criterion allows for hypothetical scenarios affecting fundamental components. In this way, ratings become measures of risk conditional on the realization of extreme scenarios (rather than conditional on the continuation of the current macroeconomic situation). See IMF, 'The Uses and Abuses of Sovereign Credit Ratings' (n 4) 91.

[161] See Luisa Izzi, Gianluca Oricchio and Laura Vitale, *Basel III Credit Rating Systems. An Applied Guide to Quantitative and Qualitative Models* (n 139) 154.

[162] See Basel Committee on Banking Supervision, 'Studies on the Validation of Internal Rating Systems' (2005) Working Papers No. 14, 2. In particular, the results of this analysis suggest that the pooled default probability assigned to each rating grade and its dynamics strongly depend on the type of rating system and the 'probability of default' estimation method.

[163] See Martin Hansen and Ebru Demir, 'Are Credit Enhancements Risk-Sensitive? A New Technique for Evaluating Structured Finance Ratings Performance' (2010) 15 *The Journal of Structured Finance* 4, 58.

of default and by the 'recovery rate' after default has occurred[164].

The myriad ways in which ratings drive investment decisions and collateral eligibility standards have attracted the attention of regulators, particularly in the wake of the recent financial crisis. In terms of rating methodology, CRAs claim that they do not target their ratings to specific credit risk metrics, such as default probabilities or expected losses, but only to ordinal rankings of credit risk. But 'despite the CRAs' goals of delivering only ordinal rankings, ratings are often used as though they map into specific credit-risk metrics'[165].

Rating methodologies evolve over time and continue to be adjusted in response to new information and economic developments. These adjustments tend to be small, and CRAs are generally careful to keep the number of rating changes triggered by these adjustments to a minimum (although there are some methodological differences among the big three CRAs, their ratings do track each other very closely).

It is important that rating activities ensure ongoing transparency, disclosure of information, monitoring and fairness of their methodologies. The quality of the rating process should be oriented to the investor perspective.

After providing an examination of the ratings methodologies, the next section analyses the discipline of conflicts of interest taking into account the major concerns of CRAs business model.

2.4 The discipline of conflicts of interest

One of the most important aspects of the governance of CRAs is how conflicts of interest are regulated. It is obvious that the issuer-pays business model raises the possibility that issuer may use, or the rating agency may perceive, monetary pressure to improve the rating[166].

Nonetheless, rating agencies exhibit potential conflicts of interest because they have a financial incentive to accommodate the preferences of bond issuers

[164] See Marwan Elkhoury, 'Credit Rating Agencies and their potential impact on developing countries' (2008) *UNCTAD*, Discussion Papers No. 186, 4.

[165] See IMF, 'The Uses and Abuses of Sovereign Credit Ratings' (n 4) 85. In particular, this research shows that CRAs' attempts to avoid volatile ratings by using smoothing practices actually make ratings more prone to procyclical "cliff effects", which in turn are amplified by the way that ratings are used as sell triggers.

[166] See Corinna Coors, 'Credit rating agencies – too big to fail?' (2012) 27 *Journal of International Banking Law and Regulation* 1, 28.

owing to the fact that they are selected and paid by the issuers[167]. This heavy dependence means ratings inflation and inaccuracy. In fact, issuers desire high ratings not necessarily accurate ratings[168].

The higher the securities rating, the less concern investors will have about payment default, the greater the liquidity and the lower the issuers' cost of capital. As a result, any investor who relies to any extent on ratings may be unknowingly bearing a risk for which they are not being compensated[169].

It is generally recognized that conflicts of interest arise at both the individual rating analyst level and the rating agency level, and it is generally considered that these conflicts are still largely unregulated[170]. However, the scholarly debate is concentrated on whether the agencies can adequately manage these conflicts.

Global regulators have affirmed that independence and conflicts of interest are the major concerns of rating procedures[171]. In particular, CRA ratings decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA's ownership structure, business or financial activities, or the financial interests of the CRA's employees.

The SEC Report noted that potential conflicts of interest arise as a result of the dependence of rating agencies on revenues from the companies they rate and the rating agencies' practice of charging fees based on the size of the

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[167] See Daniel M. Covitz and Paul Harrison, 'Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate' (2003) *Board of Governors of the Federal Reserve System Research Paper Series No. 2003-68*, 1. The authors demonstrate that rating changes are not influenced by rating agency conflicts of interest but, rather they are motivated primarily by reputation-related incentives.

[168] See Carol Ann Frost, 'Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies' (2007) 22 *Journal of Accounting, Auditing & Finance* 3, 478.

[169] See Timothy E. Lynch, 'Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment' (n 110) 247.

[170] See Lynn Bai, 'On regulating conflicts of interest in the credit rating industry' (n 112) 260. At the rating agency level, the author identifies the following potential conflicts of interest: affiliated underwriter or issuer; ancillary services to rated entities; large subscriber influence; issuer-pay business model. These conflicts are regulated under the following main provisions: U.S. Exchange Act Rule 17g-5(c)(3), Rule 17g-5(c)(5), Rule 17g-5(b)(5), and Rule 17g-5(c)(1). Despite these rules, conflicts of interest arising from large subscriber influence and the issuer-pay business model are not prohibited under the current regulatory regime, but they are still managed by internal policies and procedures (292-93).

[171] See IOSCO Technical Committee, 'Statement of Principles regarding the activities of Credit Rating Agencies' (25 September 2003); see also IOSCO Technical Committee, 'Report on the activities of credit rating agencies' (September 2003) 10-12.

issuance[172]. More precisely, the Report stressed that reliance by rating agencies on issuer fees leads to significant conflicts of interest, or otherwise calls into question the overall objectivity of credit ratings.

A related potential conflict arises in the context of underwriters attempting to influence the credit rating process. In this regard, a large amount of bond offerings are underwritten by a few large firms, and the potential conflict exists for rating agencies to rate a particular underwriter's clients more favourably in return for future business[173].

The argument is the CRAs reliance to the issuers of securities (because they have an interest in maintaining the income stream of fees from the issuers) and the ratings inflation of those securities. It has been observed that 'rating an issuer's product increases the likelihood of an issuance being successful and therefore of the issuer continuing to thrive and therefore of future issuances with their associated fee payments taking place in the future'[174].

The development of ancillary businesses (rating assessment, risk management and consulting services) provided by CRAs has increased the catalogue of conflicts.

For instance, prior to being issued with a public rating, issuers can purchase an "indicative" or private rating, along with "advice" regarding how the company might improve their rating[175]. Therefore, the purchase of ancillary services could affect the credit rating decision and issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating[176].

At this point, it is important to consider the phenomenon of "rating inflation" that occurred during the boom of structured finance. The growth of the credit derivatives market created the possibility that the use of credit ratings in counterparty collateral arrangements would produce a strongly procyclical effect (in particular, this problem occurred in the case of AIG)[177]. Indeed,

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[172] See SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (January 2003) 23.

[173] ibid 41.

[174] See House of Commons Treasury Committee, 'Banking Crisis: reforming corporate governance and pay in the City. Ninth Report of Session 2008–09' (2009) 71.

[175] See Daniel M. Covitz and Paul Harrison, 'Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate' (n 167) 6.

[176] See SEC, 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets' (n 172) 43.

[177] See Financial Services Authority, 'The Turner Review. A regulatory response to the global banking crisis' (2009) 76.

'structured products are designed to take advantage of different investor risk preferences; they are typically structured for each tranche to achieve a particular credit rating'[178].

This means that potential conflicts of interest become greater when CRAs allow issuers to take part in the rating implications of particular structuring process. The conflicts may be exacerbated when CRAs involve the executive officers of companies to discuss the rating methodology or when CRAs permit issuers to submit the details of a proposed structure to them and then advise the issuer of their likely ratings[179].

Credit rating agencies faced evident conflicts of interest during the sub-prime mortgage crisis not only by giving their highest rating to most of the collateralized debt obligations (CDOs), but also by allowing issuers to consult raters on designing the CDOs[180].

As just indicated, the main justification for these conflicts is located in the 'issuer-pays business model'. It is certainly true that the agency compensation arrangement constitutes on the face of it a *per se* conflict of interest.

Another justification could be found in the manifest shortcomings in the CRAs' internal controls. With the huge expansion in structured finance (particularly, derivative products), came a need for expert gatekeepers to evaluate them. The result was enormous profitability of credit rating agencies[181]. It should be noted that a central difference between the ratings approach for traditional debt instruments and that for structured products is that the rating assessment for structured products necessarily takes place *ex ante*[182].

But the real problem is that rating agencies know little or nothing about the underlying assets backing the securitised structures they are rating.

The central question is the issuer-agency relationship that characterizes the ratings business model. This relationship is confronted with the major conflicts

[178] See Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience' (2008) 33.

[179] See Andrew Johnston, 'Corporate Governance is the problem, not the solution: A critical appraisal of the European regulation of credit rating agencies' (2011) 11 *Journal of Corporate Law Studies* 2, 409.

[180] See Franklin Strier, 'Rating the Raters: Conflicts of Interest in the Credit Rating Firms' (2008) 113 *Business and Society Review* 4, 533. The author commenting the sub-prime mortgage collapse, implies that 'greedy lenders offered adjustable rate loans with payments that they knew many of the home-buying borrowers probably could not afford' (534).

[181] ibid. 537.

[182] See Pragyan Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth (n 131) 10. The authors observe that 'if a particular product does not attract the desired rating, the issuer can tweak the structure and resubmit it for a revised rating assessment'.

of interest questions because the interests of issuers in respect to their ratings often do not align with the needs of investors to receive reliable ratings information[183].

In particular, conflicts arise (1) when the issuer pays the rating agency evaluating the issuer's bonds; (2) when credit agencies put in place consulting arrangements with the issuers of the bonds they rate; (3) when rating agencies take the incentive to give high ratings to their clients (and a corresponding disincentive to downgrade). Consequently, 'the rating agencies have a direct hand in defining the structure that a corporation must adhere to in order to have the lowest possible cost of funding'[184].

Conflicts of interest take place when rating agencies work closely with issuers in designing structured products that the same agency will later rate (specifically, companies often use software and documents distributed by the rating agencies to show them how to satisfy the requirements for highest ratings)[185]. In other words, conflicts arise when agencies assist and facilitate their clients design structured products that they will later rate[186]. For this reason, 'ratings became almost a matter of negotiation rather than one of arm's length commercial judgement'[187].

It is worth noting that rating downgrade provokes negative consequences in terms of loss of confidence in both the issuer and the rating agency.

The consequences of a downgrade can be severe in case the bonds do default. In the same way, a tardy downgrade can be less severe because the effects of imminent bonds failure can be better absorbed by issuers (for instance in the case of Enron)[188]. It has been observed that 'the delay incentive should also be larger when the downgrade itself is particularly costly to the

[183] See on this point Charles W. Calomiris and Joseph R. Mason, 'Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings' *Economic Policies for the 21st Century* (19 April 2010) 6; see also Charles W. Calomiris, 'The debasement of ratings: what's wrong and how we can fix it' *Economic Policies for the 21st Century* (26 October 2009) 10.

[184] See Joshua Rosner, 'Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts' (2009) 14 *The Journal of Structured Finance* 4, 9.

[185] In such case, the agency receives a separate fee for this "consulting service". See Strier (n 180) 537.

[186] See Sarah Johnson, 'SEC Relies on Rating Agencies, Too' (14 February 2008) <http://www.CFO.com> accessed 27 March 2012.

[187] See Harry McVea, 'Credit rating agencies, the subprime mortgage debacle and global governance: the EU strikes back' (2010) 59 *International & Comparative Law Quarterly* 3, 712-13.

[188] See Clair A. Hill, 'Rating Agencies Behaving Badly: The Case of Enron' (2003) 35 *Connecticut Law Review* 3, 1148-51.

issuer'[189]. Therefore, the desire to generate revenues and the explicit or implicit pressure from issuers increases rating inaccuracies.

To answer the question of conflicts of interest the transparency of CRAs' governance needs to be enhanced. This means stringent controls, greater disclosure, a balanced agency-client relationship, and independence from issuers.

Firstly, proper disclosure of rating services is not sufficient to ensure transparency in the bond rating industry. Disclosure of each rating grade should be verified by independent bodies and not by the same raters. This means that publicly available information should be managed by independent controllers (such as an external body to review the CRA's governance compliance independently) before it is used in a rating assessment.

Secondly, to increase CRAs' independence from the issuers whose instruments are being rated, an independent compliance body is needed. The compliance body could monitor the relationship with the client's rating agency and evaluate the desirability of publishing a particular rating grade. Such an approach could favour the accuracy of the financial statement and realign the agency-client relationship.

Thirdly, in order to secure investor protection, a simple switch from the 'issuer-pays model' to a 'subscriber compensation model' is not a proper solution. In fact, the problem with the 'subscriber model' is the loss of compensation from "free riders" (i.e. all those who receive the information free of charge from the paying subscriber), who could benefit by a free rating[190].

To address the conflicts of interest problem a third party—the compliance officer—would be brought in who would independently hire the rating agency. Using the compliance function rather than individuals to check ratings decisions and assigning a surveillance team—separate from the initial monitoring team to track credit ratings after their initial issuance—could constitute an appropriate solution for managing the conflicts[191].

The compliance function in CRAs governance could stop the ratings from being a precondition for the sale of structured securities and reduce the CRAs' influence in advising issuers about how to structure securities in order to

[189] See Daniel M. Covitz and Paul Harrison, 'Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate' (n 167) 7.

[190] ibid 546.

[191] See Dawn Kopecki, 'The Credit Ratings Blame Game' *Businessweek* (28 September 2007) <http://www.businessweek.com> accessed 27 March 2012.

achieve the rating desired. It is obvious that conflicts of interest have larger potential market implications and should be managed by appropriate regulatory oversight.

The establishment of an independent compliance department should foster ratings stability as it would be objective, consistent, replicable, and removed from potential conflicts of interest. Compliance function would be separated from ‘modelling staff’ and would be responsible for the integrity of reporting lines.

This would protect the reputation of the agencies and increase investor confidence in the quality and objectivity of rating activities. For instance, compliance officers may detect whether employees of rating agencies are involved in possibly inappropriate rating actions.

Of course, the intent to reduce the risk of analyst conflicts of interest and ensure the objectivity and quality of analyst ratings represents the major challenge of regulators[192]. Recently, the U.S. Credit Rating Agency Reform Act of 2006 introduced a new Section 15E that requires an NRSRO to establish, maintain, and enforce written policies and procedures to address conflicts of interest[193]. Section 15E requires an NRSRO to provide information, including any conflicts of interest relating to the issuance of credit rating by the rating agency, to the SEC upon filing the registration statement by the rating agency for its NRSRO recognition (Section 15E(a)(1)(B)(vi) of the Exchange Act).

In addition, Section 15E(h) of the Exchange Act requires that ‘applicants for NRSRO and existing NRSROs establish, maintain, and enforce procedures to address and manage conflicts of interest’.

At the Community level, Article 6 of the Regulation (EC) No 1060/2009 on credit rating agencies (as amended by the Regulation (EC) No 513/2011)[194]

[192] The SEC Commission has recently launched a task force to avoid the risks of analyst conflicts; however, some criticisms of this regulatory approach have recently been expressed. See Joshua Rosner, ‘Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts’ (n 184) 17.

[193] In particular, Section 15E(h)(l) of the Exchange Act establishes that ‘each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business’.

[194] Annex III to Regulation (EC) No 513/2011 (OJ 2011 L 145 p. 30) provides a list of ‘infringements related to conflicts of interest, organisational or operational requirements’.

places an obligation on registered CRAs to ensure that credit ratings are not affected by any existing or potential conflicts of interest[195].

In particular, Annex I to the Regulation provides that 'independence and avoidance of conflicts of interest, stipulates further organizational and operational requirements with which CRAs must comply'. Whilst Annex I, section B (1), to the Regulation, requires CRAs to identify and eliminate or, where appropriate, manage and subsequently disclose, any actual or potential conflicts of interest which may influence the analyses and judgements of their analysts when determining or approving credit ratings.

At the international level, IOSCO has issued a set of principles regarding CRAs independence and the avoidance of conflicts of interest. In particular, greater attention is paid to CRAs' internal procedures and policies[196].

However, public regulators tend to delegate governance tasks and regulatory authority to specialised agents—the gatekeepers—for measuring financial risks. This kind of delegation happens 'if the perceived benefits of making use of credit rating agencies' resources through delegation are greater than the perceived agency losses'[197].

At this point, the real question is the degree of independence of the agents from the principals. Generally, agents follow the *principal's* instructions or adopt the *principal's* decisions. The major concern is that the principals are investors.

An optimal solution for avoiding conflicts of interest in rating would be to establish internal operating procedures and analyst compensation policies that reduce the link between salary and fee revenue[198]. As has been noted, 'making issuers pay introduces the potential for issuers to influence the agencies' judgements and undermine their commitment to giving investors a true account'[199].

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[195] See Article 7 of the Regulation (EC) No 1060/2009 (OJ 2009 L 302 p. 1), which requires that CRAs must ensure that anyone who is directly involved in the credit rating process is not allowed to initiate or participate in negotiations regarding fees or payments with any rated entity, related third party or any person directly or indirectly linked to the rated entity by control.

[196] See IOSCO Technical Committee, 'Code of Conduct Fundamentals for Credit Rating Agencies' (May 2008) 7-8; see also IOSCO Technical Committee, 'Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies. Final Report' (February 2011) 26-29.

[197] See Andreas Kruck, *Private Ratings, Public Regulations. Credit Rating Agencies and Global Financial Governance* (n 85) 81.

[198] See Roy C. Smith and Ingo Walter, 'Rating Agencies: Is There an Agency Issue?' (February 2001) Stern School of Business, New York University, 44.

[199] See Timothy J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness* (n 94) 151.

In this context, it can be argued that the “principal-agent theory” demonstrates that principal-agent question occurs when the agent has incentives to manage the asset in the best way for the principal[200]. Such opportunistic behaviours arise because the agent exercises his or her expertise (i.e. discretion) in a way which maximises his or her own interests, rather than those of the principal. These elements are clearly applicable to the rating agencies’ activities. In order to mitigate certain opportunistic behaviour, a third party should be interposed between the issuer and the agent. The underlying idea is that checking on agents, through an independent body, could help to limit the risks of conflicts of interest and improve transparency.

It is clear that conflicts of interest in the issuer-agency relationship increase and favour rating shopping. But it also reveals collusive (or strategic) behaviour in respect of investors[201].

Therefore, ‘regulatory intervention is needed to eliminate or at least minimize rating agencies’ incentives to engage in inappropriate rating actions and to maximize the investing public’s awareness of risks that arise from such conflicts of interest’[202]. Regulation should seek to reduce the agency problem by increasing transparency and aligning the incentives of the agent with the interests of principal.

As a final note, the fact that public regulators delegate regulatory authority to credit rating agencies, in order to improve market efficiency by making use their informational advantage, could determine a potential cause of distortion in the financial sector. Rating conflicts of interest, if not adequately addressed, constitute an evident ‘market failure’ of securities regulation.

After providing an analysis of the CRAs’ conflicts of interest, the next section provides a critical appraisal of the ratings information system taking into account the potential risks of disclosure failure.

2.5 The information disclosure

[200] See Robert Cooter and Thomas Ulen, *Law & Economics* (5th edn, Pearson International Education 2008) 431-33.

[201] See on this point Patrick Bolton, Xavier Freixas and Joel Shapiro, ‘The Credit Ratings Game’ (2009) *National Bureau of Economic Research*, Working Paper No. 14712 <http://www.nber.org/papers/w14712> accessed 28 March 2012, 2.

[202] See Lynn Bai, ‘On regulating conflicts of interest in the credit rating industry’ (n 112) 270.

Information disclosure represents a key aspect of CRA governance. As has already been observed, a rating agency is essentially a supplier of information and of the assessment of that information.

Credit rating agencies publicly disclose some of the core methodology and the basic rationale used to conduct their credit analysis. In theory, credit ratings provide valuable information to those investors who have relatively limited information gathering or analysis capacity and therefore cannot make credit evaluations as effectively as a rating agency (particularly, those investors who do not have a direct negotiating relationship with the issuer)[203].

The ratings industry was largely unregulated in terms of mandatory due diligence and informational accuracy for their analysis[204]. Global regulators have shown a manifest reluctance to provide mandatory rules that require rating agencies to check the quality and integrity of the information with which they are provided by the issuing firms[205]. In particular, poor due diligence, lack of research resources (or lack of analytical resources) and bona fide mistakes are the major criticisms levelled against the activities of the rating agencies.

It has been observed that ‘disclosure would allow third parties, including investors and other credit rating agencies, to evaluate a firm’s methods and procedures and come to market-wide conclusions about the credibility and accuracy of a rating agency’s ratings’[206]. Enhancing transparency and disclosure information would allow third parties to detect, issue, and challenge any inaccuracy.

Recent financial scandals (for instance, Enron, WorldCom and Lehman Brothers) have showed the lack of due diligence and deficiency in the evaluation of corporations’ creditworthiness. To be fair, however, ‘some of the disclosure failures reflected what may be the difficult reality of disclosing what

[203] See Timothy E. Lynch, ‘Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment’ (n 110) 242.

[204] Recently, the 2010 Dodd-Frank Act has amended Section 15E of the Securities Exchange Act to enhance the regulation and oversight of NRSROs by imposing new reporting, disclosure, and examination requirements. In the last years, the goal of increasing the transparency of NRSRO rating methodologies, strengthening the disclosures of rating performance, prohibiting NRSROs from engaging in certain practices, and enhancing NRSRO record keeping has become a major task for the U.S. Securities and Exchange Commission. See SEC, ‘2011 Summary Report of Commission Staff’s examinations of each Nationally Recognized Statistical Rating Organization’ (September 2011) 2.

[205] For instance, the 2004 IOSCO Code issued a set of principles for the activities of credit rating agencies enhancing a self-regulation approach and ‘comply or explain’ system.

[206] See Timothy E. Lynch, ‘Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment’ (n 110) 255-56.

must be, to a certain extent, a subjective process over a complex set of financial issues'[207].

These scandals revealed the CRAs' abuses in respect of investor reliance. Also, rating governance looked defective in terms of investor protection. Lack of transparency and information asymmetries reflect the fact that investors find it difficult to choose the right financial product because there is no appropriate system of disclosure. This problem is made worse by the presence of inadequate internal control rules.

For these reasons, particular attention must be paid to the information gap to which rating activities are generally subject. The imbalanced relationship between issuers and investors is principally determined by lack of financial knowledge and causes a distortion of consumers' choices, particularly at the time when the investment operation is executed[208].

The rating agencies not only should put proper arrangements in place to ensure high standards of disclosure, but also should enable the investors, by means of financial knowledge, to comprehend the 'investment grade'.

To ensure rating accountability, the market must achieve adequate disclosure protection in terms of reducing agency problems (i.e. information asymmetries) by improving the flow of price information.

In this regard, the potential way of achieving quality ratings could be afforded by effective disclosure, which would bring in its train reputation and credibility of behaviours[209]. In other words, the market's judgement would represent the primary evidence of a rating right activity, particularly through the assessment of information provided by firms.

The rating agencies' behaviours in financial transactions should be enforced by law, through mandatory disclosure and by reputation efficiency. In this context, it has been noted that mandatory disclosure can also address certain

[207] ibid 266.

[208] See Alessio M. Pacces, 'Financial intermediation in the securities markets, law and economics of conduct of business regulation' (2000) 20 *International Review of Law and Economics* 4, 499. The author focuses on the typical case of information asymmetries brought about by a lack of financial knowledge, specifically as regards the business operation managed by investors, and claims that 'individual investors are, in fact, rationally ignorant in that they lack the information and the financial expertise necessary to engage in a knowledgeable evaluation of the quality of the services provided by intermediaries'.

[209] The term 'self-induced disclosure' was coined, in academic writings, by Frank H. Easterbrook and Daniel R. Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Virginia Law Review* 4, 669-715.

agency problems (for instance by reducing the cost of monitoring promoters' and managers' use of corporate assets for self-interested purposes)[210].

Therefore, the importance of self-regulatory measures—having their origin in confidence, trust and right culture—lies in the role that they can play in bringing about sound financial stability and "market efficiency", which requires a high quality of information together with a high degree of credibility on the part of the actors concerned[211].

Opportunistic behaviours by CRAs could be avoided by means of the compliance function, as a measure falling within the category of internal self-controls, which could limit the need to regulate by statute law and reduce mandatory disclosure costs. In substance, in order to achieve allocative efficiency on the securities market, firm must be fair and competing[212].

Therefore, a system that enables direct action to be taken against persons involved in breaches of mandatory disclosure may help to promote substantive compliance according to the spirit of the law[213]. Indeed, compliant persons ensure real enforcement of the management's fiduciary duties[214].

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[210] See on this view Paul G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 *University of Chicago Law Review* 3, 1048-49.

[211] The theory of market efficiency has been developed by Ronald Gilson and Rainer Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 4, 549-644. In particular, the authors observe that 'The investment banker's role as an informational and reputation intermediary can dramatically affect the efficiency of the market's response to an innovative security' (620).

In this context, see also Zohar Goshen and Gideon Parchomovsky, 'The Essential Role of Securities Regulation' (2006) 55 *Duke Law Journal* 4, 758-65 where the authors argue that mandatory disclosure reducing the risks of asymmetric information and agency costs has a positive effect on liquidity and promotes the allocative efficiency of the securities market.

[212] See John C. Coffee Jr., 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 4, 734. Specifically, Coffee argues that 'If the securities market is intended as the principal allocative mechanism for investment capital, the behaviour of securities prices is important not so much because of their distributive consequences on investors but more because of their effect on allocative efficiency'. In particular, the author makes a critical analysis of the trend toward deregulation, in terms of price dispersion and volatility that must be monitored carefully.

[213] See Doreen McBarnet and Christopher Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 *The Modern Law Review* 6, 848 and 870, who argue that 'Creative compliance means using the law to escape legal control without actually violating legal rules; it demonstrates the manipulability of the legal system, and the system can be used not just by playing with the substance of law, as in the construction of specific formalist devices to avoid control, but by using the mechanisms of law to force out narrow rules, and using its ideologies as justification'.

[214] See Merritt B. Fox, 'Civil Liability and Mandatory Disclosure' (2009) 109 *Columbia Law Review* 2, 239-40. The key point stressed by the author is the relationship between mandatory disclosure regimes and the civil liability system; in fact, the former 'intend to promote corporate transparency, increasing social welfare by enhancing economic efficiency through better governance and increased liquidity', and the latter 'can create incentives to encourage compliance'. In sum, by imposing personal liability on the managers, it is possible to reduce the costs of damages for losses suffered by investors.

The social value of disclosure, together with the social benefits of compliance, enhances the social interest of the rating market in terms of consumer and investor protection.

In this light, the effectiveness of internal controls can allow action to be taken against behaviours amounting to misconduct and permit a sound system of risk management to be applied. However, regulation can enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents[215].

While the purpose of a credit rating is to reflect the creditworthiness of an issue or issuer, the rating agencies have some discretion in their rating system and are not required to make their rating methodology public. A registered agency could provide enhanced disclosure regarding the due diligence it undertakes when rating structured finance products and how this due diligence is incorporated into the rating process[216].

The current regulatory framework for NRSROs requires mandatory disclosures be made by rating agencies as to their rating policies and methodology[217]. However, it involves very little direct oversight of the performance of an NRSRO for the purpose of preventing or punishing poor performance.

The SEC rules only require disclosure of the rating agencies' policies regarding verification of underlying assets and information. The usefulness of such general disclosures is likely to be limited because such disclosures could be written in a way that would allow a significant amount of deviation in the use of information and extent of verification among similarly situated asset backed securities[218].

The SEC regulation introduced some disclosure requirements for CRAs. The purposes of these rules can be searched on the fact that they enhance the reputational cost to rating agencies that engage in inappropriate rating actions,

[215] See John Armour, Henry Hansmann and Reinier Kraakman, 'Agency problems, Legal strategies and Enforcement' (2009) *Harvard Law School*, Discussion Paper No. 644, 3. The authors observe that 'paradoxically, mechanisms that impose constraints on agents' ability to exploit their principals tend to benefit agents as much as—or even more than—they benefit the principals'.

[216] See Deryn Darcy, 'Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict contributed and what Regulators might do about it' (2009) *Columbia Business Law Review* 2, 648.

[217] See Kia Dennis, 'The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis' (2009) 63 *University of Miami Law Review* 4, 1144.

[218] ibid 1145.

and secondly they help break the entry barrier for smaller rating agencies with strong performance records in a market that is dominated by the main CRAs[219].

In academic circles, it has been argued that 'a major function of CRAs is to certify to relatively uninformed traders that they do not face a significant informational disadvantage'[220].

But investors' reliance on reputational intermediaries merely recreates the fraud problem one step removed. The simple result is that the principal role of reputational intermediaries is to guarantee for disclosure quality and thereby reduce information asymmetry in securities markets. However, information asymmetry in the market for reputational intermediaries limits their ability to play this role[221].

Policymakers are primarily relying on disclosure of the potential conflicts of interest and of the procedures a CRA has in place for managing the issuers' information. Consequently, investors should be able adequately to evaluate the risk that a given rating is compromised by the disclosed conflict.

In this light, one scholar has noted that 'even if CRAs are fully and fairly making mandatory disclosures on the issuer pays conflict, investors must adequately perceive and evaluate that information and must penalize CRAs via the market mechanism if disclosure is to adequately deter the agencies from reaping the gains of compromised ratings'[222].

When CRAs review and examine financial statements they rent out their reputations for conducting a careful evaluation that can catch some fraud and discourage attempts at fraud, and for painting a tolerably accurate picture of a company's performance. In this case, liability risk reinforces the rating firm's concern for reputation and can persuade the CRA to establish internal procedures to ensure transparency of the financial statements.

Reputation markets require a mechanism for distributing information about the performance of companies and reputational intermediaries. Disclosure rules

[219] See on this matter Lynn Bai, 'The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?' (2010) 7 *NYU Journal of Law & Business* 1, 51.

[220] See Dion Bongaerts, K. J. Martijn Cremers and William N. Goetzmann, 'Multiple Ratings and Credit Spreads' (2009) *National Bureau of Economic Research*, Working Paper Series No. 15331 <http://www.nber.org/papers/w15331> accessed 16 May 2012, 4.

[221] See Bernard S. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets' (2001) 48 *UCLA Law Review* 4, 788.

[222] See Deryn Darcy, 'Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict contributed and what Regulators might do about it' (n 216) 653. It is underlined that 'unless investors can force issuers to withdraw business from rating agencies that compromise their ratings, disclosure will not produce optimal incentives for CRAs to maintain integrity in their ratings processes' (658).

could help, as do reputational intermediaries' incentives to advertise their successes.

But intermediaries will not publicize their own failures, and investors will discount competitors' complaints because they come from a biased source. Formal disclosure rules are important, but are not enough.

The harder task is enforcing the rules—both direct public enforcement and indirect enforcement through private institutions, especially reputational intermediaries. Rules and financial institutions are most important for ensuring good disclosure because may include compliance officers within CRA governance.

The securities regulator's role in adopting disclosure rules is not critical to having good rules, and this role is a small part of the regulator's overall job. The core regulatory role is enforcing standards of conduct against issuers and reputational intermediaries who flagrantly violate the disclosure rules, not tweaking those rules at the margin.

After providing an analysis of the CRAs disclosure system, the next chapter examines the questions of transparency, increasing competition and accountability in the ratings market.

Chapter 3

Boosting Transparency in the Ratings Market

3.1 Transparency and market competition

The accuracy of a CRA's ratings is maintained by its need to preserve its reputation, and by competition.

It is worth noting that competition can both aid and hinder reputational commitments for quality[223]. Proper competition could reduce the phenomenon of ratings shopping—the practice of issuers to choose the best ratings from among a set of possible rating agencies. Also, increasing competition may reduce monopolistic or oligopolistic rents, and adding information to financial markets (since raters sometimes give different ratings).

[223] See Heski Bar-Isaac, 'Imperfect Competition and Reputational Commitment' (2005) 89 *Economics Letters* 2, 167.

The ratings industry has a number of specific features that raise questions about the impact of competition on the quality of information produced by agencies. Limited competition creates barriers to entry to additional competitors for two main reasons: (1) first, investor demands for global coverage with consistency in ratings; and, (2) secondly the regulatory licence enjoyed by a limited number of CRAs. Issuers have restricted choice when selecting a credible CRA to rate their security, and ensure a successful public issue.

The lack of competition in the ratings industry brings with it a number of problems including inflated issuance fee levels, limiting innovation in ratings methodologies, and the ability of just a few CRAs to miss something of significance for the market[224].

In academic circles it has been argued that competition—from an investors' perspective—could reduce bias because of the pressure to be accurate. However, competition need not reduce and may increase bias if consumers want to hear reports that conform to their priors[225].

In assessing corporate default risk, creditors and financial analysts need transparent financial information.

Transparency is essential to clear up not only the opacity involving the agencies' methodologies, but also the perceptions and misconceptions surrounding the unsolicited ratings activity. Other concerns such as the spreading use of rating-triggers and speculative issuer's behaviour can be tackled by increased transparency.

Transparency should be extending to identifying whether a rating has been solicited and the nature of any rating triggers within instruments which are rated.

The regulators should nonetheless try to minimize these existing threats by increasing transparency and strengthening the reputation mechanism. Consequently, transparency would help the market's understanding of a rating.

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[224] See Angus Duff, 'The credit ratings agencies and stakeholder relations: issues for regulators' (2009) 24 *Journal of International Banking and Financial Law* 1, 12.

[225] See Harrison Hong and Marcin Kacperczyk, 'Competition and bias' (2008) *Working Paper* <http://ssrn.com/abstract=1101626> accessed 16 May 2012, 1. It is observed that 'there are two offsetting effects of competition on accuracy: (1) less competition means less accuracy since analysts can be as optimistic as they want; (2) less competition means less forecast dispersion and hence more accuracy' (31).

The concerns about the lack of proper competition and transparency prompted the US regulator to introduce new legislation, the 'Credit Rating Agency Reform Act of 2006', which formalised the registration process and introduced measures designed to improve the conditions for competition, procedural transparency and operational oversight[226].

The SEC adopted a series of rules to further enhance the transparency of rating methodologies and performances and to strengthen NRSROs' recordkeeping and reporting obligations, in order to assist the SEC in monitoring NRSROs' compliance with regulation. It has been argued that 'these extensive disclosure rules represent an attempt to ensure both methodological and performance transparency'[227].

The present normative framework requires each CRA registered as an NRSRO to disclose its rating performance in terms of historical default rates and rating transitions[228]. One important component of the CRA regulation is the requirement that rating agencies disclose statistics that measure the accuracy of their ratings and their historical rating actions.

The normative schemes for CRAs have attempted to fulfil the transparency gap in relation to the ratings process, as well as the rigour and consistency of the methodologies used by CRAs.

However, the process of obtaining NRSRO status has been criticized for its lack of transparency regarding qualifications and for effectively limiting the number of certified rating agencies[229]. It has been observed that 'true competition would allow unsolicited NRSROs to issue pre-sale and ongoing reports to the investment community'[230].

[226] See Tin A Bunjevac, 'Credit Rating Agencies: A Regulatory Challenge for Australia' (2009) 33 *Melbourne University Law Review* 1, 47.

[227] See Andrew Johnston, 'Corporate governance is the problem, not the solution: A critical appraisal of the European Regulation on Credit Rating Agencies' (n 179) 432. The author asserts that 'as regards performance transparency, this appears to be an attempt to reinforce the operation of reputation and so compel CRAs to operate with appropriate levels of diligence' (433).

[228] See on this matter Lynn Bai, 'The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?' (n 219) 79.

[229] See on this matter Elizabeth Devine, 'The collapse of an empire? Rating agency reform in the wake of the 2007 financial crisis' (2011) 16 *Fordham Journal of Corporate & Financial Law* 1, 191-92.

[230] See the Statement of Sean Egan Co-founder and Managing Director (Egan-Jones Ratings Co.) before the U.S. Securities and Exchange Commission 'Credit Rating Agencies Roundtable', Washington, 15 April 2009, 9-10.

At the European level, Regulation No 1060/2009 provides a set of rules for implementing transparency in respect of CRAs' internal governance[231]. The Regulation aims to correct the transparency failures by introducing measures relating to the internal governance of CRAs. In particular, CRAs are required to complete and publish an annual 'transparency report' containing detailed information about their legal structure and ownership, internal quality control systems, record-keeping policies, description of its management and rating analyst rotation policy[232].

Also, CRAs are required to disclose the outcome of the annual internal review of its independent compliance function and financial information on the revenue of the credit rating agency. Most importantly, CRAs must disclose the details of their ownership composition and clients in order to make the governance management transparent. For an informational asset like a rating, an important dimension of control over this asset regards its disclosure[233].

It is relevant to note that the main CRAs do not show an independent ownership structure. Precisely, Fitch IBCA is owned by FIMALAC S.A., a French financial conglomerate, Standard & Poor's is owned by McGraw-Hill Companies, Inc., an influential publishing and media company, and Moody's Investors Service is managed by Dun & Bradstreet, a leading U.S. business information company.

The ownership composition of the main CRAs leaves many doubts on the real independence of rating activities. The aforementioned owners of CRAs are powerful companies listed in the securities markets. This means that they play an active role in the financial sectors and may put pressure on financial transactions.

In particular, McGraw-Hill Companies, Inc. and FIMALAC S.A. are dominant firms in the information network providing business services (i.e. business information report) and publishing financial magazines. The worldwide business information group Dun & Bradstreet (Moody's main

[231] See in particular Annex I, Section E ('Disclosures') to Regulation No 1060/2009 (OJ 2009 L 302 p. 1).

[232] In this context, the European Commission has recently issued Regulation No 446/2012 of 21 March 2012 (OJ 2012 L 140 p. 2), Regulation No 447/2012 (OJ 2012 L 140 p. 14), Regulation No 448/2012 (OJ 2012 L 140 p. 17) and Regulation No 449/2012 (OJ 2012 L 140 p. 32).

[233] See Antoine Faure-Grimaud, Eloïc Peyrache and Lucía Quesada, 'The ownership of ratings' (2009) 40 RAND *Journal of Economics* 2, 235.

shareholder) has set up subsidiaries in each European country and generally has a large stake in the local markets for business information.

These considerations can be significant in respect to the type of claim rated by the main CRAs: (1) debt, preferred stock of corporations, sovereigns, governments and structured financing for Fitch IBCA; (2) bonds (sovereigns, corporations, financial institutions, pooled investment vehicles, structured finance, thrifts, public finance, public utility), bank deposits and commercial paper for Moody's Investors Service; (3) bonds from corporations, financial institutions, infrastructure finance, insurance, managed funds, public finance, sovereigns and structured finance for Standard & Poor's.

A rating agency's reputation would tend to be bolstered if it avoided conflicts of interest created when the rating agency is owned, managed, or influenced by the institutions being rated.

Other sources of credit risk assessment—particularly in the banking system—such as Central Credit Registers (CCRs)[234] and Central Financial Statements Databases (CFSDs)[235] are owned and managed by European central banks. They are mainly influenced by the banking industry and their management is shared by central banks. These rating institutions play a significant role for credit institutions because they offer banks a useful instrument for monitoring customers' exposure and comparing their lending policy with that of competitors[236].

Closer examination of the CRAs' ownership suggests that, on the one hand, the regulatory reforms should attempt to secure transparency, through strong enforcement measures. On the other, it completely leaves to the rating agencies the function of monitoring the management structure. However, a more explicit reference to the transparency rules implemented at the European and U.S. level would have been desirable.

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[234] The service provided by Central Credit Registers (CCRs) involves collecting, processing, managing and releasing information on banks' credit exposures. The general goal of CCRs is to enhance the transparency of banking activities and make those activities secure.

[235] The Central Financial Statements Databases (CFSDs) service involves the credit quality of counterparties to which banks are exposed. CFSDs are generally used to determine eligibility of corporate debt instruments in central banks' banking refinancing procedures, banking supervision, and economic research.

[236] See Basel Committee on Banking Supervision, 'Credit Ratings and Complementary Sources of Credit Quality Information' (August 2000), Working Papers No. 3, 55-61.

In this way, the Council of the European Union has recently published a general position to mitigate the risk of conflicts of interest[237]. In detail, the proposal would require CRAs to disclose publicly if a shareholder with 25% or more of the capital or voting rights holds 25% or more of the rated entity.

Additionally, this proposal aims to ensure the diversity and independence of credit ratings and opinions, prohibiting ownership of 25% or more of the capital or the voting rights in more than one CRA[238]. Moreover, a shareholder holding at least 5% of the capital or the voting rights in a CRA would have to publicly disclose ownership of 5% or more of the capital or voting rights of any other CRA.

The clear objective of the European regulator is to enhance transparency measures in order to improve the reliability of the CRAs' rating methodologies. Also, the task force launched by Community regulations aims to reinforce the ESMA's power of supervision[239].

In academia, one scholar has argued that 'transparency is a collective good that must be established by regulation'[240]. It is manifest that the rating process needs to become more transparent because of the unregulated label placed by CRAs on the creditworthiness of securities.

Another author has suggested that the most effective approach to a more transparent rating system could be a two-step due diligence requirement by which professionals employed by issuers and underwriters provide complete and verified data to the rating agencies who then document the statistical models they apply to the data and their application[241]. Transparent financial information and disclosures can be achieved by adopting effective internal control systems and promoting value policies of the firm[242].

[237] See Council of the European Union, 'Credit rating agencies: General approach agreed ahead of talks with EP', Presse 214, Brussels, 21 May 2012.

[238] See Articles 8-11 of the Regulation No 449/2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards on information for registration and certification of credit rating agencies (OJ 2012 L 140 p. 32).

[239] See the Regulation No 447/2012 'supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies by laying down regulatory technical standards for the assessment of compliance of credit rating methodologies' (OJ 2012 L 140 p. 14).

[240] See Bernard S. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets' (n 221) 797.

[241] See Elizabeth Devine, 'The collapse of an empire? Rating agency reform in the wake of the 2007 financial crisis' (n 229) 198.

[242] See Samir M. El-Gazzar, Kwang-Hyun Chung and Rudolph A. Jacob, 'Reporting of Internal Control Weaknesses and Debt Rating Changes' (2011) 17 *International Advances in Economic Research* 4, 421.

The question of ratings performance would probably be less prominent if there were proper competition. Securities markets rely on the CRAs oligopoly which has developed, principally through merger and acquisition rather than natural growth. This development has been favoured by regulatory actions in financial markets (for instance the NRSRO designation system) and by the absence of action from the normally zealous anti-trust and competition authorities[243].

Because CRAs largely lack effective price competition, ‘the lethargy characteristic of monopolies may shield them from competitive pressures that otherwise would encourage service quality’[244].

Merely enhancing more NRSROs does not mean there will be more competition[245]. Smaller firms and new entrants face the significant problem of developing the very reputational capital the current NRSROs claim to be so central to their continued operation.

Some commentators claim that increasing the number of rating agencies would worsen the shopping problem and reduce welfare[246].

On this view, fostering new entries into the ratings business may not necessarily make it more efficient in terms of rating quality[247]. The reward from maintaining reputation would be lower because competition implies that the market is shared between a larger numbers of rating agencies[248].

Consequently, there is no particular reason to believe that new CRAs entries would improve the quality of ratings. Others have contested this, arguing that ‘a new entrant could establish a track record for greater accuracy—independently assessed—in a particular niche by exploiting a comparative advantage, say in rating one particular product line, with a small staff, and then build from that’[249].

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[243] See on this view Thirlwell J, ‘The Credit Rating Age (Part II). The Call for Control’ (2004) 12 *RBC CM Open Forum Notes*, 2.

[244] See Thomas J. Fitzpatrick, IV and Chris Sagers, ‘Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations’ (2009) *Cleveland-Marshall College of Law*, Research Paper 09-171, 25.

[245] ibid 30.

[246] See Vasiliki Skreta and Laura Veldkamp, ‘Ratings shopping and asset complexity: A theory of ratings inflation’ (2009) 56 *Journal of Monetary Economics* 5, 678-80.

[247] See Jerome S. Fons, ‘Rating Competition and Structured Finance’ (2008) 14 *The Journal of Structured Finance* 3, 9.

[248] See Nelson Camanho, Pragyan Deb and Zijun Liu, ‘Credit Rating and Competition’ (2010) *London School of Economics Financial Markets Group*, Discussion Paper No. 653, 2. The authors demonstrate two effects of competition: the disciplining effect and the market-sharing effect.

[249] See Charles A E Goodhart, ‘How, if at all, should Credit Ratings Agencies (CRAs) be

Others, for their part, have observed that competition among specialized financial intermediaries can lead to full credible information disclosure, even in the presence of only small reputation costs[250]. Precisely, on this view, competition fosters the provision of information and reduces conflicts of interest[251].

Competition should be encouraged so that all agencies which are recognised and used by the market operate on a level playing field. That means the markets also must open their processes to new or specialist agencies and not rely on the main CRAs.

Therefore, without competitive pressure rating agencies are unlikely to change their methodologies. Because there is little outside pressure, the regulators should focus their efforts on increasing the number of players (i.e. the 'inside pressure')[252]. More new rating agencies mean more competition, but older and more reputable CRAs are a safer bet for high quality ratings, because they have more to lose from a recognition withdrawal[253].

Since such competition could hardly do any harm from the allocation perspective, it is certainly sensible for the regulators to take competition increasing measures.

Several potential problems of efficiency and anticompetitive behaviour would be attenuated by more competition. However, the principal fear of increased competition is a breakdown of the reputation mechanism leading to deteriorating quality. Additional competitors could produce rating inflation. On this view, competition by itself is not the right answer.

Transparency and competition would be greatly facilitated by proper disclosure of CRAs and could favour innovation and accountability of the ratings activities[254]. It has been observed that 'in the rating market, where

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Regulated?' (n 55) 31-32.

[250] See Patrick Bolton, Xavier Freixas and Joel Shapiro, 'Conflicts of interest, information provision, and competition in the financial services industry' (2007) 85 *Journal of Financial Economics* 2, 298. It is observed that 'competition both reduces the gains from lying and induces financial institutions to disclose information in order to differentiate their products and thus relax price competition'.

[251] ibid 317-18.

[252] ibid 137. The author observes that 'one has to accept that the credit rating industry is framed by exceptionally strong forces hindering competition – it is a natural oligopoly at best' (138).

[253] ibid 141.

[254] See Milosz Gudzowski, 'Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency' (2010) *Columbia Business Law Review* 1, 274-75.

quality presumably cannot be determined in advance, quality is rewarded because high-quality producers amass reputational capital'[255].

Ratings transparency and competition are important factors for the regulatory use of CRAs. More disclosure and transparency of CRAs methodologies make important sense in the current regulatory framework.

A regulatory environment that enforces accurate financial disclosure by firms wishing to issue securities also helps to enhance the flow of reliable information to investors. Transparency should improve rating reliability, facilitate investor diversification and decrease market uncertainty.

Credit rating agencies provide influential information to market participants and need to be pressurised to provide adequate disclosure about their own methodology.

After considering the questions of rating transparency and competition—taking into account the ownership composition of the main CRAs—the following section attempts to provide tentative suggestions to make credit rating agencies accountable.

3.2 Making credit rating agencies accountable

Rating agencies should provide appropriate rating of the debt liability and default events owing their duty to the market and be liable for any faulty forecasting[256].

In particular, it should be stressed the question whether inaccuracy of ratings could potentially give rise to a private right of action for investors.

In this respect, it is important to give due consideration to the common law 'promissory estoppel' doctrine, particularly estoppel by representation (or estoppel by conduct)[257] in which 'the mere fact that a person is precluded from denying the truth of something he has said does not involve him in any

[255] See John Patrick Hunt, 'Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' (n 37) 138. The author distinguishes between two types of transparency: (a) methodological transparency—an outsider's ability to tell just how the agencies reach the ratings they award—and (b) performance transparency—the ability to discern how well the ratings perform.

[256] See on this point Ben Chu, 'Greek rescue blocked by hedge fund greed' *The Independent* (London, 18 January 2012).

[257] A first application of the 'estoppel by conduct' can be found in *Lickbarrow v. Mason* [1787] 2 TR 63, 100 ER 35. See Lord Halsbury in *Henderson v. Williams* [1895] 1 QB 521. See also *Pickering v. Busk* [1812] 15 East 38; *Boyson v. Coles* [1817] 6 M. & S. 14; *Spear v Travers* [1815] 4 Camp. 251; *Martini v. Coles* [1813] 1 M. & S. 140.

liability'[258]. Generally, estoppel is a shield not a sword[259]. To what extent this is true depends on the jurisdiction.

In other terms, CRAs could be potentially liable under the doctrine of estoppel (the assumption that the statement was true; and where the promise is intended to create legal relations giving the promisee a cause of action in damages)[260].

Under the estoppel doctrine, CRAs could be found potentially liable for their inaccurate assessment vis-à-vis investors[261]. The fact that credit ratings provide a public statement (or 'mere opinion') of financial products causes legal effects to attach to consumers' expectations[262].

If CRAs claim that they issue a simple opinion of the creditworthiness of issuer, this type of opinion—resulting in a wrong belief—could be analysed as falling within the doctrine of promissory estoppel[263].

In this way, the doctrine of estoppel is applicable because of the detrimental

[258] See Guenter Treitel, *Some Landmarks of Twentieth Century Contract Law* (OCP 2002) 38.

[259] See the cases *Crabb v. Arun D.C.* [1976] Ch. 179, 188; *Woodhouse A.C. Israel Cocoa Ltd v Nigerian Product Marketing Co Ltd* [1972] AC 741, 757.

[260] The origin of 'estoppel principle' derives by Lord Denman judicial opinion in *Pickard v. Sears* [1837] 6 A. & E. 469 and *Freeman v. Cooke* [1848] 2 Ex. 654: 'where one by his words or conduct wilfully causes another to believe the existence of a certain state of things, and induces him to act on that belief, so as to alter his own previous position, the former is concluded from averring against the latter a different state of things as existing at the same time'. In the literature, it has been observed that 'estoppel is a consequence of someone's words or behaviour, in virtually any context, but only where the words or behaviour have had an effect on someone else'. Reliance is a pervasive precondition for estoppel, and this is usually described as detrimental reliance. See Elizabeth Cooke, *The Modern Law of Estoppel* (OUP 2000) 17 and 62. For promissory estoppel cases, see Lord Denning in High Trees House, *Combe v Combe* [1952] EWCA Civ 7, etc. See also *Hedley Byrne v Heller* [1963] 3 WLR 101.

[261] See on this matter A. L. Pickering, 'Estoppel by Conduct' (1939) 55 *Law Quarterly Review* 3, 407-10. The author argues that 'estoppel by conduct generally arises from a misrepresentation of fact made to an innocent person upon the faith of which he changes his position to his prejudice'. See Lord Tomlin in *Greenwood v. Martins Bank* [1933] AC 51; see also *Thompson v Palmer* [1933] 49 CLR 507.

[262] Let us suppose that there are two market participants, A and B, that A (for instance, a credit rating agency) represents to an investor of financial products (B) that those products have high quality, when they are not. Although A may be estopped from denying the truth of that statement, that does not make him liable to the investor and in this sense the estoppel does not give rise to a cause of action. In this case, rating agency A might, if he were negligent, be liable for misrepresentation; but that liability is based on the fact that the statement was *false* while any liability by estoppel would be based on the opposite assumption, i.e. that the statement is *true*. See on this example Guenter Treitel, *Some Landmarks of Twentieth Century Contract Law* (n 258) 35.

[263] See in the scholarly debate Kristofor W. Nelson, 'Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?' (2009) 63 *University of Miami Law Review* 4, 1178 and 1191. The author comments on an important judicial opinion (*Atlantic Masonry v. Miller Construction*, 558 So. 2d 433, 434—Fla. 1st DCA 1990) in which is stated that 'although the investors do not have a direct contractual relationship with the ratings companies, courts have held that third parties are entitled to relief under the doctrine of promissory estoppel'.

reliance of investors, that is to say, because the representees have relied upon the CRAs representation to their detriment[264]. The effect of estoppel rule (as a defence not as a cause of action)[265] in credit ratings could prevent the agencies from denying, or going back on what they said[266]. Also, the doctrine of promissory estoppel could be invoked against the CRAs in order to protect the consumers' expectation interest[267].

With these considerations in mind, it is possible to examine some critical aspects of CRAs where questions frequently arise and in which the regulation should provide adequate legal responses.

What is crucial for the operation of the legal protection for investors is the soundness of CRAs' actions in interpreting disclosed information and assessing the creditworthiness of companies, thereby increasing investor confidence.

In this regard, it may be argued that one of the key manifestations of a market's "fairness" or "orderliness" is its transparency. Such transparency may then allow investors to allocate their resources in an informed manner, creating an efficient market. Hence, it may be argued that 'efficiency' is a key manifestation of the quality of fairness and orderliness in markets.

CRAs should be required to make their ratings more transparent by disclosing information about the assumptions underlying their methodology on a rating-by-rating basis. Also, the board members of the rating firms must be independent.

Consequently, the staff of CRAs should create policies regarding their processes that must be certified by the firm's chief executive. Essentially, adequacy of disclosure is a gauge to determine what an investor knew or should have known based on the information available to it.

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[264] See on this point Alfred T. Denning, 'Recent Developments in the Doctrine of Consideration' (1952) 15 *The Modern Law Review* 1, 9. The author points out that 'cases where there is no promise but only conduct by one party which leads the other party reasonably to believe that the strict legal rights will be waived, modified or discharged. In those cases the first party will not be allowed to insist upon his strict legal rights after the other party has acted to his prejudice unless he first takes steps to remove the prejudice'.

[265] Precisely, where the estoppel is one by representation there is no effect of giving rise to a cause of action. See *Low v. Bouverie* [1891] 3 Ch. 82 and *Derry v. Peek* [1889] 14 App. Cas. 337.

[266] In this context, 'estoppel is triggered by words, behaviour, or silence leading someone to believe in a state of affairs'. See Elizabeth Cooke, *The Modern Law of Estoppel* (n 260) 70.

[267] See M. P. Thomson, 'From Representation to Expectation: Estoppel as a Cause of Action' (1983) 42 *Cambridge Law Journal* 2, 266-69. The author argues that (1) estoppel is based on the fact that an expectation has arisen and (2) estoppel operates as a rule of evidence. See also Elizabeth Cooke, 'Estoppel and the protection of expectations' (1997) 17 *Legal Studies* 2, 285.

In order to improve due diligence services (for instance, investigations as to the suitability of rating models), independent experts, such as compliance officers, could be appointed. This type of third party services could prove a strong incentive to issue accurate ratings.

However, the real concern is how to make rating agencies truly independent. A possible suggestion could lie in an internal body such as compliance department (i.e. a compliance officer) with functions of detecting the historic performance of ratings and verifying their methodologies. An independent compliance department could check the due diligence of agencies' reports and disclose all information about rating procedures.

Also, an internal compliance department could offer rating agencies the incentive of a lighter supervisory relationship for managing the risks in their assessment effectively. Specifically, the compliance officer could provide an active monitoring service to ensure that developments in the business and specific obligations meet the required standards of legality and integrity. In other words, in order to protect financial transactions, satisfactory internal control mechanisms (such as an independent compliance function) should be put in place by a cogent regulatory organization[268].

It will then be necessary to investigate the strategic behaviour of CRAs in respect of issuers because of their potential collusive actions. Also, this analysis aims to verify whether this collusive behaviour faces a problem of cooperation, and if this cooperation produces mutual gains for those who participate[269].

The strategic behaviour of rating agencies and issuers may be exacerbated in CRAs' governance where there are different parties with different interests in the outcome of transactions.

In order to attempt to tackle these issues, it is relevant to consider the implications of principal-agent theory in order to investigate to what extent conflicts of interest and information asymmetries exist as between the issuer,

[268] See on this point Caitlin M. Mulligan, 'From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors' (2009) 50 *Boston College Law Review* 4, 1300-01.

[269] The cooperative behaviour is addressed by the 'repeated game theory' in which is explained why people engage in actions which produce joint benefits greater than private costs in two-person relationships. See Eric A. Posner, *Law and Social Norms* (Harvard University Press 2000) 18.

the ratings agency and investors[270].

Assuming the principal-agent theory[271], it is explained how to recast the rating agencies-investors relationship. However the issuer-agency relationship present between the issuer-CRA raises questions from regulators and investors[272]. In particular, issuers (principals) without sufficient information or expertise to implement their preferences employ agents (rating agencies) who possess such expertise.

Unless constrained (for example by proper regulation) agents may be able to exploit their discretion so as to advance their own interests, rather than those of their principal. Still, the agent may sacrifice the best interests of both investors and issuers for the agent's own personal self-interest. In this context, criticisms arise over the inability of CRAs to assess the market risk of structured financial products[273].

Closer examination of the issuer-agency relationship enables some conclusions regarding the need of protection for consumers.

The most effective way of solving the principal-agent problem in the credit rating might be to realign the interests of the issuers and agencies. CRAs may be concerned to further their interests in relation not only to issuers but also to investors. The agency problem facing credit ratings is connected with the need of issuers to develop a reputation for credibility. Fully informed investors should provide a natural disciplining influence on poorly-performing credit ratings.

Some commentators have argued that 'gatekeepers [like CRAs] have an

[270] See Tony Van Gestel and Bart Baesens, *Credit Risk Management* (n 107) 124. In particular, the authors observe that 'the issuer credit rating is an overall judgement of the obligor's ability to meet his financial commitments. Issuer credit ratings reflect the issuer's fundamental credit risk, hereby making abstraction of security-specific differences related, e.g., to seniority, collateral, and/or guarantees'.

[271] According to the economic literature, a principal-agent problem occurs when one individual engages a skilled person to undertake some profit-making, or other utility-conferring activity. Typically, because of the principal's lack of expertise, a significant incentive to interact in imperfectly competitive environments is conferred on the agent, with the risk that the latter may opportunistically exercise that discretion in a way which maximises his or her own interests, rather than those of the principal. The regulation can constrain the relationship between principal and agent, but fails to prevent opportunistic behaviour. In other terms, the principal-agent problem is intended as 'a contract that gives the agent the incentives to manage the asset in the best way for the principal'. See Robert Cooter and Thomas Ulen, *Law & Economics* (Pearson International Education 2008) 147.

[272] See Gillian Tett, 'E-mails throw light on murky world of credit' *Financial Times* (London, 25 April 2010).

[273] See Committee on the Global Financial System (CGFS), 'Ratings in structured finance: what went wrong and what can be done to address shortcomings?' (July 2008) *CGFS* Papers No. 32, 3-5.

incentive to disappoint buyers only when the resulting gains exceed the costs of building reputation; but if sellers often find cheating profitable, buyers will discount the value of the reputational signal accordingly—and in the extreme case, the reciprocal expectations that support reputation will collapse under the weight of moral hazard'[274]. Through their individual reputation, gatekeepers have the power to influence the product value and pressure the expectations of market participants. In this light, gatekeepers should be directly responsible to the investors for their performance.

According to Coffee's view, the gatekeepers fail to report to a principal, which results in a situation of conflict of interests[275]. In substance, the issuer wants the inflated rating less for its impact on the market than for its ability to reduce its regulatory costs. However, the issuer may misrepresent the information supply to the gatekeeper; but this misconduct behaviour could be detected or prevented by an internal supervisory body.

The introduction of a strong *principal* to monitor the *agent* should cost little and produce quantifiable benefits[276]. A strong incentive for the principal may consist in the presence of a compliance officer.

From this point of view, the compliance function could improve the reputational and legal constraints on issuers. Then the compliance officer could act to monitor risk management for issuers and rating agencies.

In this context, liability rules could furnish a powerful incentive to strengthen the screening accuracy of CRAs[277].

In order to answer these questions, it is possible to note that compliance could certify both the accuracy of ratings assessment and the high quality of the financial product. Through the compliance function, CRAs may signal their value to investors because the reputational value of rating agencies depends on the level of their screening accuracy.

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[274] According to Reiner H. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (n 6) 97. The author argues that 'reputations are particularly important where buyers cannot verify the quality of goods or services prior to their purchases, and enforceable warranties prove costly or ineffective'.

[275] See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (n 6) 335-37.

[276] ibid 338.

[277] See on this point John C. Coffee Jr., 'Enhancing Investor Protection and The Regulation of Securities Markets' (n 60) 69. In particular, 'credit rating agencies must be compelled either to conduct reasonable verification of the key facts that they are assuming in their ratings methodology or to obtain such verification from professionals independent of the issuer'. For this obligation to be meaningful, it must be backstopped by a standard liability specifically designed to apply to credit rating agencies.

Consequently, the compliance officer could play the role of a new *agent* for the purposes of monitoring ratings. In addition, the compliance function would have the incentive to control its agent (rating agency) on grounds of consumer protection.

This would realign the principal-agent relationship. Investors should become the principal who hires and fires the gatekeeper; then the CRAs should act in the public interest and not in their own interest.

Again, the large problem has to do with the weakness of the incentives that motivate the CRAs when playing a gatekeeper role. The weakness concerns reputational improvement and investment controls.

Specifically, the fact that CRAs are not accountable under a self-regulatory system could determine an allocative inefficiency of resources. Such inefficiency may be correlated with risks of uncompleted information supplied to investors. This information gap is commonly underlined in the credit rating services where issuers may have not the incentives to disclose information.

After providing a critical analysis of CRAs accountability, the next section investigates the phenomenon of ratings over-reliance and attempts proposals to consider CRAs responsible for misrepresentation or detrimental reliance.

3.3 The risks of over-reliance on credit ratings

A primary source of overreliance may be a misperception of what ratings represent. In this context, it has been observed that 'the finance industry is grappling with the detrimental effects of the ratings regulation it already has'[278].

The regulatory use of credit ratings has contributed to investors' undue reliance on ratings and favoured the artificially high demand for highly rated financial instruments. Excessive reliance on inaccurate credit ratings of financial products (particularly structured finance instruments) has facilitated the spread of recent financial turmoil.

More specifically, the regulatory use of credit ratings increasingly depends on government acceptance rather than on the extent to which they provide real

[278] See Harold Furchtgott-Roth, Robert W. Hahn and Anne Layne-Farrar, 'The law and economics of regulating ratings firms' (2007) 3 *Journal of Competition Law & Economics* 1, 76. It is argued that in credit and bond ratings there is a clear market failure; and the proposed legislative solution for bond ratings may not go far enough in removing previous regulatory failures, but would at least be a step in the right direction (92).

value to market participants. This means that 'market discipline increasingly is being replaced by government discipline'[279].

An example of government reliance on CRAs can be found in the "Talf Initiative" (the U.S. Term Asset-Backed Securities Loan Facility program)[280], in which rating agencies play the role of arbiters in determining eligible assets. Under the Talf Initiative, 'regulators have given the rating agencies … the authority to determine to which category a particular bond belongs, by whatever method they see fit'[281].

Government use of CRAs has increased the practice of relying blindly on credit ratings' internal models to assess credit risks.

Inaccuracy of credit ratings could distort the market's reputational incentives[282]. One scholar has noted that if credit ratings value rested only on their unique informational input and the reliability of this information, the failure of CRAs to provide accurate, up-to-date ratings would be sanctioned by market forces, acting on reputational incentives'[283]. The lower transparency and greater complexity in the securities markets ensured a heavy reliance by financial participants on rating agencies[284].

Governmental intrusion in rating activities could exacerbate excessive reliance on ratings if market participants believe these carry a governmental 'seal of approval'. Many investors did rely on these ratings and considered them not only to be expert opinion but authorized seals of approval[285]. The issue that regulatory intervention runs the risk of exacerbating excessive

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[279] See Philippe Bergevin, 'Addicted to Ratings: The Case for Reducing Governments' Reliance on Credit Ratings' (2010) C.D. Howe Institute Backgrounder Issue No. 130 <http://ssrn.com/abstract=1657881> accessed 22 May 2012, 1.

[280] On 25 November 2008, the Federal Reserve Board launched a credit facility program ("TALF Initiative"). The "TALF" was intended to assist the credit markets in accommodating the credit needs of consumers and small businesses by facilitating the issuance of asset-backed securities (ABS) and improving the market conditions for ABS more generally.

[281] See Arturo Cifuentes, 'Insight: Time we rated the bond graders' *Financial Times* (London, 27 July 2009).

[282] Such reliance on credit ratings could have a material influence on financial transactions—for instance altering the price of securities—provoking a potential distortion in the market mechanisms. See Christopher C. Nicholls, 'Public and Private Uses of Credit Ratings' (n 17) 24.

[283] See Amélie Champsaur, 'The regulation of credit rating agencies in the US and the EU: recent initiatives and proposals' (May 2005) *Harvard Law School*, Seminar in International Finance, LL.M. Paper, 30. It is explained that 'in view of the discrepancy between reliance and reliability (what credit ratings are and what they should be or what the marketplace expect them to be) and the dangers of reliance *per se,* two concurring policy options would seem to make sense: increasing reliability of and decreasing reliance on credit ratings' (35).

[284] See Jonathan Katz, Emanuel Salinas and Constantinos Stephanou, 'Credit Rating Agencies' (October 2009) *The World Bank Group*, Note No. 8, 3.

[285] See Steven Scalet and Thomas F. Kelly, 'The Ethics of Credit Rating Agencies: What Happened and the Way Forward' (2012) 105 *Journal of Business Ethics* (online) 2, 1.

reliance on ratings seems evident—particularly because of high incentives for investors to rely uncritically on ratings as a substitute for independent evaluation[286]. Regulatory reliance on CRAs transformed these 'media opinions' into a sort of official approval for companies needing access to the capital markets.

The Basel Committee argues that a key concern in the financial crisis was the fact that market participants relied excessively on external ratings instead of conducting the necessary due diligence in order to understand the risks underlying the rated instrument[287]. In this light, Basel II explicitly allows banking regulators to permit banks to use credit ratings from approved rating agencies in calculating their net capital reserve requirements.

Reliance on external ratings could undermine incentives to conduct independent internal assessments of the credit quality of exposures. Such reliance on the ratings of the main rating firms—crystallised by the SEC and NRSROs—raises barriers to entry and discourages innovation in the provision of bond creditworthiness information.

The powerful effect of the regulators' reliance on the judgments of CRAs is shown by the importance of their pronouncements in bond markets[288]. It is worth considering that eliminating the regulatory dependence on credit ratings may be the best way to foster a competitive environment for the credit rating industry[289]. Regulators should simply stimulate investors not to use the same ratings and analysis.

CRAs are incorporated into financial regulation and into private contracts and investor guidelines. In fact, a ratings benchmark is used in sensitive private covenants through the inclusion of trigger clauses related to the credit ratings[290]. This could create a source of demand for ratings that is not tied

[286] See Sarah Pei Woo, 'Stress before Consumption: A Proposal to Reform Agency Ratings' (2012) 18 *European Law Journal* 1, 77. The author observes that 'it is difficult to reduce reliance on ratings by market participants generally, as references to ratings and ratings triggers pervade investment guidelines, swap documentation, loan agreements, collateral triggers, and other important counterparty documents' (78).

[287] See Basel Committee on Banking Supervision, 'Strengthening the Resilience of the Banking Sector' (2009) Consultative Document <http://www.bis.org/publ/bcbs164.htm> accessed 24 May 2012, 55.

[288] See Lawrence J. White, 'The Credit Rating Agencies' (2010) 24 *Journal of Economic Perspectives* 2, 214.

[289] See Rolf H. Weber and Aline Darbellay, 'The regulatory use of credit ratings in bank capital requirement regulations' (2008) 10 *Journal of Banking Regulation* 1, 10.

[290] See Vassiliki L. Papaikonomou, 'Credit rating agencies and global financial crisis. Need for a paradigm shift in financial market regulation' (2010) 27 *Studies in Economics and Finance* 2, 166.

directly to their quality. An issuer may demand a rating because investors need the rating to fulfil regulatory or other requirements, even if neither party believes that the rating is a high quality assessment of creditworthiness.

It has been noted that overdependence on ratings was a central component of the credit crisis[291]. It is considered, however, that this shifts the emphasis away from the major failures of the credit ratings agencies in terms of the lax and opaque way they addressed the information asymmetries and conflicts of interests as between issuers and investors.

Also, these failures need to be seen in terms of "reputational value" on financial markets, particularly when the misrepresentations in signalling default risks are taken into account.

This emerged in the case of the subprime defaults, corporate scandals—such as Enron, Arthur Andersen, etc.—and most recently in connection with the Greek crisis in 2011-2012, when rating agencies classed the country as a stable credit risk and investors relied on their authoritative opinions, with the negative consequence of lack of fairness in the market. Their failure to warn investors of the imminent collapse—together with their subsequent action in re-rating Greek debt—caused consumers to suffer huge losses and led to market failures for financial sectors including banks and investment companies.

A way to impose a restriction on rating agencies' reliance is to expose them to liability for careless services. In this way, it has been argued that 'the primary cost of permitting suits to go forward is that any downgrade would presumably invite a lawsuit, however frivolous'[292].

From a regulatory perspective, the Financial Stability Board published a set of 'Principles for Reducing Reliance on CRA Ratings'[293]. This Report applies

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[291] See Frank Partnoy, 'Overdependence on Credit Ratings was a Primary Cause of the Crisis' (2009) *University of San Diego School of Law*, Legal Studies Research Paper Series No. 09-015, 17. The author affirms that the boom of second-level securitization transactions rises with substantial overdependence on credit ratings. In fact, 'without the ability to obtain high ratings for Collateralized Debt Obligations (CDOs) and Structured Investment Vehicles (SIVs) tranches, there would have been little appetite for overpriced lower-rated mortgage collateral'.

[292] See John Crawford, 'Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry' (2009) 42 *Connecticut Law Review - CONNtemplations* 1, 19.

[293] See Financial Stability Board, 'Principles for Reducing Reliance on CRA Ratings', 27 October 2010, 1. It is stated that the "hard wiring" of CRA ratings in standards and regulations contributes significantly to market reliance on ratings. This is a cause of the "cliff effects" during the recent financial crisis, through which CRA rating downgrades can amplify procyclicality and cause systemic disruptions.

the principles not only to the regulatory use of ratings, but also to a wider range of financial market activities and market participants—including central bank operations, investment mandates and private sector margin agreements.

These principles aim to reduce "mechanistic" reliance on CRA ratings and establish stronger internal credit risk assessment practices instead. Specifically, the reliance on CRA ratings should be reduced in 'standards, laws and regulations' and in markets more generally[294].

In this regard, the UK Treasury Committee Report pointed out that 'one possible way to decrease over-reliance is to increase investors' knowledge about credit ratings'[295]. Particularly, the Committee suggests that more information about the scope of ratings, how they are formulated and what information they use may better equip individuals to make their own judgments about the quality of a rating.

At the European level, the recent proposals for a directive and a regulation set out to amend existing legislation on CRAs in order to reduce investors' over-reliance on external credit ratings, mitigate the risk of conflicts of interest in credit rating activities and increase transparency and competition in the sector[296].

More specifically, the draft directive seeks to amend current directives on undertakings of collective investment in transferable securities (UCITS)[297] and on alternative investment funds managers (AIFM)[298] in order to reduce these funds' reliance on external credit ratings when assessing the creditworthiness of their assets.

In the U.S., the 2010 Dodd-Frank Act has increased accountability for CRAs while attempting to improve SEC oversight and make it easier for

[294] See Pragyan Deb, Mark Manning, Gareth Murphy, Adrian Penalver and Aron Toth, 'Whither the credit ratings industry?' (n 131) 13-14. The authors observe 'any efforts to reduce reliance on CRA ratings should be supported by adequate transparency of issuer information, so as to permit private credit assessment by a wider range of market participants' (17).

[295] See House of Commons Treasury Committee, 'Banking Crisis: reforming corporate governance and pay in the City. Ninth Report of Session 2008–09' (n 174) 73. In a similar vein, see Nicolas Véron, 'Rating Agencies: An Information Privilege Whose Time Has Passed' (2009) Bruegel Policy Contribution 2009/01, Briefing Paper for the European Parliament's ECON Committee, 6. In particular, the author argues that 'new regulations should ensure that any material information provided by issuers to the rating agencies should be made available to the entire marketplace through public disclosure'.

[296] See Council of the European Union, 'Credit rating agencies: General approach agreed ahead of talks with EP' (n 237).

[297] See Directive 2009/65/EC (OJ 2009 L 302 p. 32).

[298] See Directive 2011/61/EU (OJ 2011 L 174 p. 1).

investors to sue rating agencies in private litigation[299]. The Act reduces over-reliance on credit ratings but it does not eliminate regulatory uses of credit ratings. It has been noted that 'the SEC and federal regulators, as well as state and local lawmakers, have the ratings embedded in many of their rules—effectively requiring investors to trust the ratings'[300].

As indicated earlier, the complexity and diversity of financial products—particularly structured finance products—represent the prime cause of over-reliance on ratings because investors do not have the expertise or resources to research into each product. This means a huge reliance on ratings assessment, but also raises concerns about the potential damages if other market participants (i.e. issuers or investors) suffered a loss due to an infringement committed by the agency intentionally or with gross negligence.

Investors or issuers would be able to claim damages from a CRA for losses caused by misrepresentation or detrimental reliance. The misrepresentation theory holds a party liable whenever 'she knows (or should know) that [her] promise will appear to be more reliable than it is'[301].

The legal question is whether the disappointed investor is instead entitled to compensation. Another question is whether the disappointed party would be able to claim both reliance damages and expectation damages under the promissory estoppel doctrine[302]. The consideration of promissory estoppel rule

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[299] See on this matter Stephen Harper, 'Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act' (2011) 68 *Washington and Lee Law Review* 4, 1951. Under the Dodd-Frank Act, investors, for purposes of pleading the required state of mind in a private right of action for damages against CRAs, must only set forth facts supporting an inference that the CRA knowingly or recklessly failed: (i) to conduct a reasonable investigation of the facts it relied on in its credit rating; or (ii) to obtain verification from other independent sources (1953).

[300] See Sarah Johnson, 'SEC Relies on Rating Agencies, Too' (n 186). It is observed that 'the Securities of Exchange Commission's own rules use the ratings to make distinctions among investment grades and to pick out securities that could be put through a faster registration process than those with a lower grade'.

[301] See Randy E. Barnett and Mary E. Becker, 'Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentation' (1987) 15 *Hofstra Law Review* 3, 491.

[302] See W. David Slawson, 'The Role of Reliance in Contract Damages' (1990) 76 *Cornell Law Review* 1, 199. Professor Slawson argues that promissory estoppel concerns the enforcement of a promise on the grounds of reliance. Therefore, promissory estoppel makes a promise binding only if the promise is one "which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character" (208). See also Andrew Robertson, 'Reliance and Expectation in Estoppel Remedies' (1998) 18 *Legal Studies* 3, 368. Reviewing the promissory estoppel cases, the author affirms that taking a reliance-based approach to the question of remedy is the only way of doing justice between the parties.

In jurisprudence see *The Commonwealth v. Verwayen* (1990) 170 CLR 394, where the High Court of Australia held that reliance loss cannot be compensated properly without meeting the expectation. In a similar vein see *Waltons Stores (Interstate) Ltd v. Maher* (1988) 164 CLR 387.

is due by the fact that some promissory misrepresentations are remedied, though no remedy would be available under traditional contract and tort doctrines[303]. However, estoppel is not a cause of action, although it may support a cause of action by blocking a defence[304]. Estoppel is not used for the direct enforcement of promises.

Consequently, estoppel cannot by itself entitle a claimant to a remedy for a factual situation. This means that estoppel cannot be used to obtain a remedy for a misstatement[305].

Some scholars have asserted that detrimental reliance is either essential for, or irrelevant to, promissory estoppel liability[306]. Some courts have recognized liability for misrepresentation under the promissory estoppel rule[307].

In *Jordan v. Money*, the court held that estoppel can only arise from statements of fact and not from promises, so that the estoppel rule cannot be used to enforce promises[308].

The point under examination is whether one party can expect value of a transaction by relying on a certain circumstance, and may enforce the commitment, in order to be compensated for damages deriving by this reliance. In the scholarly debate, it has been questioned that 'is it reasonably foreseeable to a CRA that its credit ratings will be relied upon by investors, and would such reliance, typically be reasonable'[309].

Whether there is any liability may depend on whether the party attempting to withdraw said anything the law will interpret as a "promise" on which the

[303] See Randy E. Barnett and Mary E. Becker, 'Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentation' (n 301) 446. The authors underline that 'although there is no need for a remedy for misrepresentation in the absence of reliance, reliance alone cannot determine the standard of liability for misrepresentation' (496-97).

[304] See Elizabeth Cooke, *The Modern Law of Estoppel* (n 260) 118-19. Estoppel prevents from asserting or denying something with result that the court will not hear the assertion or denial.

[305] ibid 124. The author argues that 'an action for misstatement may succeed only because estoppel blocks a particular defence; but it must succeed on the basis of the tortuous principles of deceit or negligent misstatement'.

[306] See Michael B. Metzger and Michael J. Phillips, 'The Emergence of Promissory Estoppel as an Independent Theory of Recovery' (1983) 35 *Rutgers Law Review* 3, 512. See also Daniel A. Farber and John H. Matheson, 'Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake" (1985) 52 *University of Chicago Law Review* 4, 905; see Juliet P. Kostritsky, 'A New Theory of Assent-Based Liability Emerging Under the Guise of Promissory Estoppel: An Explanation and Defense' (1987) 33 *Wayne Law Review* 3, 899-905.

[307] See *Walker v. KFC Corp.,* 515 F. Supp. 612 (S.D. Cal. 1981); *Goodman v. Dicker*, 169 F.2d 684 (D.C. Cir. 1948); *Werner v. Xerox Corp.*, 732 F.2d 580 (7th Cir. 1984).

In these cases, the courts have used promissory estoppel to impose liability for negligent promissory misrepresentation instead of traditional contract and tort remedies.

[308] See *Jordan v. Money* (1854) 5 HLC 185.

[309] See Christopher C. Nicholls, 'Public and Private Uses of Credit Ratings' (n 17) 24.

other party "reasonably" relied. Reliance is a form of relationship-specific investment[310]. Consequently, reliance always involves some risk to the relying party.

The reliance measure puts the injured party in as good a position as if the contract had never been made. Reliance in ratings decisions may turn out to be a wise decision, if nothing goes wrong and the transaction is executed, but it will turn out to be unwise if something prevents the deal from going through[311]. Similarly, reliance on a CRA's evaluation will bind the CRA only if the evaluation is one which the CRA should "reasonably expect" to induce issuer's reliance[312].

In this context, the case law seems more inclined to treat the issuer's reliance as binding if his reliance appeared to increase the expected value of the transaction, so that even the CRA would have wanted to be committed[313].

A court could reject expectation damages unless it can estimate them with reasonable accuracy. This will be the case where there is insufficient evidence or where the expectation damages are too indefinite to provide an estimate of how much loss the claimant has suffered.

In *RCM Supply Co. v. Hunter Douglas, Inc.*, the court affirmed that damages recoverable under a claim of detrimental reliance are carefully circumscribed. The plaintiff may recover only those specific expenditures made in reliance upon the defendant's promise[314].

The amount of damages is set by the expectation measure, because this is the amount required to put the injured party in as good a position as if the promise had been performed[315]. In assessing damages, 'courts should balance deterrence factors against the financial burden imposed on CRAs and the risk of market failure in the market for CRA services'[316]. Basically, courts should

[310] See Richard Craswell, 'Offer, Acceptance, and Efficient Reliance' (1996) 48 *Stanford Law Review* 3, 490. The author observes that 'since reliance involves both potential losses and potential gains, the efficient level of reliance—that is, the level of reliance that will maximize the total expected value of the proposed transaction—can be defined by the balance of the potential gains and losses'.

[311] ibid 502.

[312] ibid 532.

[313] See the case *Drennan v. Star Paving Co.*, 51 Cal.2d 409, 333 P.2d 757 Supreme Court of California, [1958]. See also *Hoffman v. Red Owl Stores Inc.*, 133 N.W.2d 267 (Wis. 1965).

[314] See the United States Court of Appeals for the Fourth Circuit reversed the district court's judgment for RCM case, 686 F.2d 1074 (4th Cir. 1982), 1079.

[315] See W. David Slawson, 'The Role of Reliance in Contract Damages' (n 302) 217.

[316] See Stephen Harper, 'Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act' (n 299) 1971. The author points out that 'this tier-based system with liability caps should

use different levels of liability depending on the ground of negligence (i.e. simple negligence, gross negligence or recklessness).

Misrepresentation by CRAs could be regulated in order to protect investors against information asymmetries and discretionary and fraudulent activity. Further, the reputation value of CRAs should be regulated in order to satisfy the need to protect investors and issuers.

In sum, the market's reliance on a small number of CRAs presents a difficult policy problem. In these terms, it seems better to increase the disclosure process and transparency in the ratings activities.

With these considerations in mind, an achievable way of securing accountability of CRAs would be a regime of civil liability which would enable investors to seek redress in court—for example in class-actions, direct claims procedures or alternative procedures such as mediation and arbitration.

The following section illustrates the current regulatory reforms put in place at the European level taking into account the critical perspectives raised in the scholarly debate.

3.4 The regulatory reforms of ratings market

The key to a successful deal for a corporate issuer is securing the right credit rating. It is evident that companies and investment banks are not simply market-makers, or disinterested parties acting on behalf of clients. The interest to promote risky products and complicated financial schemes is the core business of securities issuers.

Recently, a SEC investigation revealed that prominent investment banks had bundled 'toxic mortgages into complex financial instruments, got the credit rating agencies to label them as AAA securities, and sold them to investors, magnifying and spreading risk throughout the financial system, and all too often betting against the instruments they sold and profiting at the expense of their clients'[317]. Also, one of the main players in the credit rating market was notified by the SEC that it could face civil charges on the ground that it had

be adopted because it offers an appropriate model for deterring CRA misconduct without bankrupting CRAs'.

[317] See United States Senate Permanent Subcommittee on Investigations, 'Wall Street and the Financial Crisis: Anatomy of a Financial Collapse' (13 April 2011) 6-7.

violated federal securities laws in connection with its rating of a structured finance vehicle before the crisis[318].

In substance, CRAs were accused of having made unrealistic assumptions about structured finance products in order to issue AAA ratings[319]. CRAs claim that their assessment explicitly does not address market pricing or trading liquidity for the security in question, but rather focuses on the likelihood of default events.

Another question is the fact that a few main agencies (Standard & Poor's, Moody's and Fitch) in the financial market provide ratings that have become too deeply embedded in the regulatory capital assessment system.

As observed previously, credit ratings are used in a slew of regulations from bank capital rules to collateral requirements at central banks.

All that Standard & Poor's and others do is to offer an opinion on the likelihood of sovereign bonds being repaid, which is a legitimate activity. Issuers pay for ratings because, in the long run, this deepens the pool of investors. But the 'issuer-pays' business model that characterizes the relationship between a given ratings agency and issuers is fraught with manifest conflicts of interest.

The problem is how well CRAs do their job. Rating agencies activities suggest a valuable degree of independence from issuers. The crux of the matter is 'because rating agencies make their rating determinations based primarily on information provided by the issuer of securities, a rating is no more reliable than that information'[320].

It is clear that the 'certification' role of CRAs underlines the reliance which is placed in their gatekeeper function. Because CRAs' influence on market prices, not only in terms of disclosure information, but also in terms of outlooks, reviews and watch warnings, their views have impacted on

[318] On September 22, 2011, The McGraw-Hill Companies, Inc. received a "Wells Notice" from the Staff of the U.S. Securities and Exchange Commission (the "Commission") stating that the Staff is considering recommending that the Commission institute a civil injunctive action against Standard & Poor's Ratings Services, then a division of The McGraw-Hill Companies, Inc. ("S&P"), alleging violations of federal securities laws with respect to S&P's ratings for a particular 2007 offering of collateralized debt obligations, known as "Delphinus CDO 2007-1". See also Kara Scannell and Shannon Bond, 'SEC in court threat to S&P over financial crisis' *Financial Times* (London, 26 September 2011).

[319] See Financial Crisis Inquiry Commission, 'The Financial Crisis. Inquiry Report', Final Report of the National Commission on the causes of the financial and economic crisis in the United States (January 2011).

[320] See Steven L. Schwarcz, 'The Role of Rating Agencies in Global Market Regulation', in Eilís Ferran and Charles A E Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001) 299.

investment grades, and the debate transcends national borders. Some options to prevent agencies exerting such power could be to stop promoting them or, to motivate institutional investors to look for alternative sources of credit information.

These options stem from the fact that 'the increased reliance on ratings reduced the reputational constraints on credit-rating agencies. Rating agencies became more important and more profitable, not necessarily because they generated more valuable information, but because they began selling more valuable regulatory licenses'[321]. The prospect of these solutions happening could help to open the ratings market and stimulate the leading CRAs to improve their performance.

It is significant to note that 'reputational capital' and reputation alone are not a workable constraint on gatekeeper certification. It further postulates that it is necessary to bolster the ratings service with an independent oversight figure in order to help manage the complex global regulatory landscape and improve dialogue with investors, regulators and the public.

Consumers are often unable to draw inferences regarding the reputation and reliability of the rating agency when the assessment takes place. CRAs should enhance the information available to consumers. In other terms, investors should be ensured of the appropriate level of information on which to make decisions. It is evident that some individual investors are unskilled and make poor decisions about risk even when they have obtained full information about the products.

As a result, the question of the reliability of credit ratings and the influence of the main rating agencies (Standard & Poor's, Moody's and Fitch) constitute major tasks in the financial sector.

The CRAs' business model is fraught by conflicts of interest insofar as ratings are intended to guide investors but are paid for by companies and in some cases governments. In short, the main rating agencies remain dominant and markets, central banks and regulators tend to take their statements too seriously.

The CRAs fail to give a convincing answer to fundamental questions: to

[321] See Frank Partnoy, 'Historical Perspectives on the Financial Crisis: Ivar Kreuger, the Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets' (n 30) 441. Professor Partnoy stresses that these regulatory licenses created incentives for bond issuers to obtain ratings before bonds were issued.

what extent do their activities contribute to market confidence and are they indispensable for growth of the financial sector? That is one of the central questions that the CRAs have failed to answer.

The recent financial turmoil has provided strong arguments for opponents of the CRAs, but looking at the evolution of the credit ratings the only surprise is that it took so long before any serious concern materialised.

As noted earlier, securities regulation has recently sought to restore confidence in CRAs by striving to fill the major gaps in ratings governance, namely the conflicts of interest arising from the ‘issuer-pays’ model, the methodology and data sources used by CRAs.

At the European level some wide reforms are on the agenda. In particular, the European Commission has set a vast programme to re-regulate the CRAs in which it seeks to address the major concerns, such as the limited competition in the market for credit ratings, rating agency independence and the agencies’ activities[322].

The Commission proposes requiring issuers to rotate the agencies that rate government bonds[323]. The idea is to prevent the incumbent agency’s analysts from becoming too chummy with issuers and therefore too lenient. In addition, the Commission proposes to force issuers of financial products regularly to change the rating agency they are using, in a bid to open up competition and avoid conflicts of interest[324].

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[322] See European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies’, COM(2010) 289 final; European Parliament, ‘Resolution of 8 June 2011 on credit rating agencies: future perspectives’, (2010/2302(INI)) and Regulation No 513/2011 of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies (OJ 2011 L 145 p. 30). Recently, Commission has issued a proposal amending Regulation (EC) No 1060/2009 (COM(2011)747 final) and a proposal amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings (COM(2011)746 final).

[323] In particular, the EU proposal seeks to overhaul the rating industry and forces issuers to rotate the rating agency they use at least every three years, and in some cases every year. See Alex Barker, ‘Rating agencies seek to block EU reform’ *Financial Times* (London, 6 November 2011). The powerful lobbying being deployed against similar proposals for auditing firms shows the sort of resistance that the Commission can expect also in the case of the CRAs.

[324] On 24 January 2012, the ECON Committee hearing drew up a comprehensive state of play of the positions on Credit Rating Agencies after the proposed draft regulation and directive on CRA III was adopted on 15 November 2011. In particular, the draft proposal has four main objectives: *i*) to reduce overreliance on ratings: the draft regulation requires the ESAs to reduce reliance on ratings when drafting technical standard and the draft directive addresses overreliance from UCITs and AIFM; *ii*) to increase transparency on sovereign debt, with requirements regarding the frequency of ratings and on timing; *iii*) to enhance competition and reduce conflicts of interest, through the introduction of a rotation principle and of rules

It should permit to address two of the major concerns of the rating industry: (1) the near-total domination of the market by the main three rating agencies; and, (2) the dubious issuers-rating agencies relationship.

The reforms propose giving wide-ranging powers to ESMA to approve ratings methods and ban sovereign ratings in ‘exceptional situations’ (or in ‘inappropriate moments’)[325]. Specifically, the European regulators would be given powers to suspend credit ratings of countries receiving emergency financial assistance[326].

However, it has been argued that ‘any ability for ESMA to suspend sovereign ratings may damage the independence of the credit rating agencies in the eyes of the financial markets’[327].

But the CRAs watchdog would have the difficult task of enforcing ratings uniformly, potentially preventing laxer countries from undermining common standards and limiting the ability of countries to add additional requirements[328].

By the same token, it has been proposed at the Community level that credit rating agencies could be banned from downgrading countries in the eurozone bailout scheme. In fact, some European countries have been extremely critical about the manner and timing of certain sovereign debt rating decisions during the current euro zone crisis, although the CRAs have defended their behaviour[329]. Other proposals include the establishment of a new independent ratings agency and different models to mitigate conflicts of interest in the current ‘issuer pays’ model.

However, these proposals could prove to be ineffectual because rating methods necessarily evolve over time to reflect innovations by underwriters, new legislation and changes in the financial market.

In this regard, members of the European Parliament have called on the

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regarding cross-ownership; *iv*) to introduce a civil liability regime for CRAs in case of gross negligence or intentional infringement of the Regulation.

[325] According to the Regulation No 513/2011 (OJ 2011 L 145 p. 30), ESMA can conduct investigations, ongoing inspections and impose fines directly on credit rating agencies that breach European Union rules. See Nikki Tait, ‘EU body empowered to fine rating agencies’ *Financial Times* (London, 3 December 2010).

[326] See Alex Barker, ‘EU shake-up for rating agencies’ *Financial Times* (London, 20 October 2011).

[327] See AFME, ‘AFME comment on the European Commission’s proposals for Credit Rating Agencies’ (Press Release, 16 November 2011) <http://www.afme.eu> accessed 17 November 2011.

[328] See Brooke Masters, ‘Rating agencies fall under EU supervision’ *Financial Times* (London, 31 October 2011).

[329] See Alex Barker, ‘A glimmer of hope for credit rating agencies’ *Financial Times* (London, 11 November 2011).

European Commission to establish a public European credit rating agency that would produce impartial ratings without being constrained by commercial considerations[330]. The European Parliament also suggests looking at the possibility of establishing a network of smaller European rating agencies, in an effort to bring more competition into the industry[331]. But this proposal has already met with considerable scepticism, not least because of the perceived lack of independence of such an agency.

The major concern is that more information should be made available to investors and that the legal liability of rating agencies for negligent ratings should be enhanced.

Concerns about rating 'downgrading' has made CRAs unpopular, in particular on account of the inconvenient timing of their published opinions. Financial institutions are still searching an appropriate solution for CRAs *modus operandi*. However, criticisms of rating agencies may appear legitimate where their predictions seem to suggest that they may be motivated by some speculative intent[332].

Moreover, speculation about rating agency downgrades of countries sovereign debt influences trading on the markets. This notwithstanding, the main rating agencies claim that this is an inevitable consequence of issuing independent opinions—such opinions are only one measure of risk.

Downgrades are not only a reflection of reality but groundbreaking new information on account of the speculative effects of the downgrade on the markets. Credit rating agencies should face a lagging indicator rather than a leading one. They should verify the market's judgement rather than lead it.

There was evidently a race to downgrade among the main rating agencies; it seems that the rating agencies now compete with each other in order to be the first to identify risks that will lead to the next sovereign debt crisis. Therefore, it is important to reveal how CRAs influence securities market fluctuations and investors' decisions. The risk of such influence could be addressed by a new regulatory framework guaranteeing responsibility and accountability for CRAs opinions.

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[330] See Geraldine Lambe, 'CRA: regulation with bite or toothless?' *The Banker* (London, June 2011).

[331] See Nikki Tait, 'Brussels faces rating agency dilemma' *Financial Times* (London, 7 July 2011).

[332] See on this point Bo Becker and Todd Milburn, 'How did increased competition affect credit ratings?' (2009) Harvard Business School, Working Paper No. 09-051, 10.

As already indicated, the major function of CRAs is to certify the quality of the product. However, some scholars have argued that there is a trade-off between rating evaluations and market stability[333]. Empirical studies demonstrated that the focus of agencies on long investment horizons explains only part of the relative stability of agency ratings[334]. Also, other academic studies showed a possible balance between rating stability, rating timeliness and default prediction performance[335].

If the role of CRAs is solely to forecast the creditworthiness of financial instruments, it is possible to underline an imbalance between downgrade evaluations and market confidence. It has been observed that 'as gatekeepers, the credit rating agencies did not monitor clients closely after the point of their initial rating. Thereafter, rating downgrades generally followed the market, rather than led it'[336].

One key concern is whether rating downgrades may destabilize financial markets, particularly when downgrades cross into non-investment grade categories. The information provided by CRAs is regarded as being a public good[337].

Consequently, CRAs should supply freely information not only to issuers who have paid for it (and can benefit from this information), but also to investors that rely on them. By keeping a record of the outcome of their rated instruments, rating agencies provide a public service. Through their trustworthy reputation they constitute suppliers of *independent* information for consumers. In this regard, it has been argued that 'a rating is valuable only if everybody knows it, and you cannot get an investor to pay for information he already has. Ratings are a public good, that have two possible paymasters:

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[333] See Richard Cantor and Christopher Mann, 'Analyzing the Tradeoff Between Ratings Accuracy and Stability' (2007) 16 *The Journal of Fixed Income* 4, 60-64.

See also the interesting articles by Kara Scannell, 'SEC makes S&P downgrade inquiries' *Financial Times* (London, 11 August 2011) and Tobias Buck, 'Rating agencies hit by subprime probe' *Financial Times* (London, 16 August 2007).

[334] See Edward I. Altman and Herbert A. Rijken, 'How rating agencies achieve rating stability' (2004) 28 *Journal of Banking and Finance* 11, 2679-80.

[335] See Edward I. Altman and Herbert A. Rijken, 'The effects of rating through the cycle on rating stability, rating timeliness and default prediction performance' (2005) New York University Working Paper No. FIN-04-032, 26-27.

[336] See John C. Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (n 6) 324-25.

[337] It is generally considered by the economic literature that 'a public good is one where the consumption of the good by one individual in no way prevents others consuming the good or diminishes their enjoyment of it'. In other terms, a public good is one where there is no rivalry and non-exclusion in consumption. See, for all, David M. Kreps, *A Course in Microeconomic Theory* (Harvester Wheatsheaf 1990) 168.

government or issuers'[338].

Investors—as market participants—should be made aware of the uncertainties surrounding future predictions of default events. So there is a public interest in achieving accountability for this publication of results. But the question at issue is, therefore, how global regulators can tailor a proper legal framework for CRAs. Consequently, how the current self-regulation regime can be turned into a hard-law regime.

After considering the current regulatory reforms designed at the European level, the following section provides some concluding observations.

Concluding Remarks

This research has attempted to demonstrate that the current regulatory framework for CRAs is defective and fallacious in terms of informational asymmetries, laxity of regulation, absence of transparency, conflicts of interest and limited competition.

In particular, the analysis underlined the weakness of the present regulatory regime for CRAs and suggested a possible solution designed to enhance the accuracy of ratings and encourage the disclosure of information.

In this regard, it has been emphasised that the lack of care shown in the CRAs' activity is such as to cause 'damage' to the financial market in the event that their 'predictions' are not accurate and respond instead to political concerns and those of lobbies[339].

Also, the investigation has showed that there is a need for an independent internal body with the function of checking the accuracy of CRAs' opinions of default events[340]. These agencies usually rate the credit default risk of the assets to which they give a particular rating.

This aspect has been misinterpreted because rating covers market and liquidity risk as well. Regulators could require the financial industry to

[338] See Avinash Persaud, 'The right direction for credit rating agencies' *Financial Times* (London, 18 October 2007).

[339] See Philip Stephens, 'Downgrade the rating agencies' *Financial Times* (London, 20 January 2012).

[340] See Charles A.E. Goodhart, *The Regulatory Response to the Financial Crisis* (n 55) 121.

standardise what ratings mean, instead of every ratings agency having its own complicated organization.

In order to address these questions, this research has assumed that a structural reform of CRAs' internal governance is required. The analysis has argued that reform of the CRAs is to be preferred over free market solutions that permit anyone to issue credit ratings and anyone to rely on them[341].

Specifically, the research has attempted to propose a new normative regime in which CRAs are subject to closer regulation and liability regime. Consequently, it has been defined a regulatory environment in which credit rating agencies can play a useful and efficient role as informational intermediaries.

In addition, the research has provided a critical assessment of the CRAs activities through the study of decided cases.

The investigation of strategic behaviour has highlighted the nature of the interaction (or cooperation) between rating agencies and issuers in order to ascertain whether they cooperate to maximize their joint profits regardless of the consumers[342].

However this part of research has illustrated how CRAs make their predictions in presence of agency problems (moral hazard and adverse selection)[343], informational asymmetries and transaction costs (or bargaining costs)[344].

This analysis has considered situations in which there are few decision-makers and in which the optimal action for one person to take depends on what another actor chooses.

Some tentative suggestions have been provided for keeping the effectiveness of CRAs' action and the protection of investors aligned, so that

[341] The analysis has intended to extend the point made by Coffee. See John C. Coffee Jr., 'Ratings Reform: The Good, The Bad, and The Ugly' (n 40) 5-6.

[342] In this context, it has been observed that 'incomplete information is the central problem in game theory and the law'. See on this point Douglas G. Baird, Robert H. Gertner and Randal C. Picker, *Game Theory and the Law* (Harvard University Press 1994) 2.

[343] In the economic literature, moral hazard occurs in the insurance problems when the behaviour of the insuree changes after the purchase of insurance so that the probability of loss tends to increase. So 'where one party to a transaction may undertake certain actions that affect the other party's valuation of the transaction but the second party cannot monitor or enforce perfectly'. Vice versa, adverse selection occurs where 'one party to a transaction knows things pertaining to the transaction that are relevant to but unknown by the second party'. For these definitions, see Kreps, *A Course in Microeconomic Theory* (n 337) 577.

[344] In this context, the research has assumed as 'bargaining costs' only the information costs between parties. By assuming the bargaining costs between CRAs and issuers, it is possible to analyse their strategies.

people who pursue profits also benefit the public.

Therefore, the investigation of CRAs strategic behaviour has been carried out to understand what kind of regulatory tools are needed for rating agencies. Once again, incomplete information is the central problem of the rating agencies/investors relationship.

However, another question is to understand how these parties bargain with each other and the way in which they split the information.

It is relevant to note that adequate investor protection against market distortions requires trustworthiness and reliability. In this regard, credit ratings should encourage 'market efficiency' through their gatekeeper role.

The major task for CRAs is to improve investor protection by requiring greater transparency and more disclosure. Consequently, in order to avoid failures on the part of CRAs it is necessary that these agencies should resume their role of promoting financial awareness.

In conclusion, CRAs should ensure investor protections policy ought to reduce a firm's cost of capital and thereby encourage investment[345]. Investment, in turn, ought to pay off in faster growth. Rating agencies sell information about the risk of securities products.

The various ways the information is used by financial, legal and regulatory entities may influence the nature of the information production process. This means that CRAs not only should provide safety in assessing the risks of investing in security products, but also should reduce information asymmetry in the issuer-investor relationship.

[345] In the words of Moody's, '[Moody's] is an essential component of the global capital markets, providing credit ratings, research, tools and analysis that contribute to transparent and integrated financial markets. The purpose of Moody's ratings is to provide investors with a simple system of gradation by which future relative creditworthiness of securities may be gauged'. See Moody's website <http://www.moodys.com/Pages/atc.aspx> accessed 8 February 2012.

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