Foreword

Credit rating agencies have become the first port of call for corporate issuers, investors and financial institutions in assessing credit risk and for determining compliance with regulatory requirements. The multitude of regulations that require credit ratings to be used for assessing credit risks and that only a few designated rating agencies are allowed to issue official ratings has had the effect of limiting competition in the ratings industry and contributing to market failures. As a result, rating agencies have acquired immense influence and power, particularly in financial markets. The failure of the ratings industry to provide accurate risk assessments was demonstrated with the collapse of Enron and the bursting of the Dotcom bubble in the early 2000s and later with the collapse of the US residential mortgage market and structured finance and securitization markets in 2007 and 2008. These market and regulatory failures led to calls for fundamental reform of the regulation of the ratings industry. Although there have been numerous studies examining how poor governance and conflicts of interest at rating agencies created the moral hazard that led to grossly optimistic assessments of risk in the mortgage and wholesale debt markets, few have systematically analyzed how credit ratings have come to influence the development of financial markets over the past century and how regulation of the ratings industry and the use of credit ratings in regulatory requirements have played a key role in substantially limiting competition in the credit ratings industry and how regulatory reforms in Europe and the US continue to fail to address the regulatory and financial risks posed by the ratings industry.

Aline Darbellay’s *Regulating Credit Rating Agencies* is an important work that addresses these issues. The book shows how the ratings industry developed and came to play such an important role in influencing not only investor behavior, but also the structure of financial markets. In doing so, the book traces the historical development of the ratings industry in the United States in the late nineteenth and early twentieth centuries and how the US regulatory reforms of the 1930s led to a move away from the investor-pays model to the issuer-pays model of credit ratings and how ratings began to be embedded in US financial regulation. The book discusses the conflicts of interest and moral hazard that can be
attributed to the issuer-pays model to the extent that rating agencies may award higher ratings in order not to jeopardize business relationships with their client issuers. This was especially the case with rating agencies that awarded AAA ratings to structured finance products that were arranged by investment banks – such as, for example, Barclays Capital, Merrill Lynch, UBS, Lehman Brothers and Goldman Sachs – in the period before the global financial crisis began in 2007. The weaknesses in this model contributed to a financial crisis from which the global economy has not yet recovered and has led to regulatory reforms, such as the US Dodd-Frank Act of 2010, that seek to expunge ratings from all financial regulatory requirements.

The book details how the evolving regulatory framework governing the ratings industry and the regulation of institutional investors and prudential bank regulation provided the main impetus for the systemic role that rating agencies play in today’s global financial markets. Other important parts of the book detail how the regulation of rating agencies and the issuance of credit ratings of financial instruments became important drivers of financial innovation and growth in the equity, wholesale debt and structured finance markets. The book’s outstanding contribution to the literature will be to show how financial regulation itself has led to an uncompetitive oligopolistic structure in the ratings industry and how this has impaired the quality of ratings, particularly in assessing investment risks for regulated institutional investors and in determining the level of regulatory capital for banks and other financial institutions and the implications for financial stability and the efficient operation of financial markets.

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