1. Introduction

1.1 BACKGROUND

These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little bit of both.1

The leading credit rating agencies (CRAs) Moody’s, Standard & Poor’s and Fitch gained prominence in the financial markets.2 Since the global financial crisis hit the world economy in 2007, significant concern has been raised about the role of CRAs and the use of their credit ratings. Recent events have attracted the attention of regulators, lawmakers, market participants and academic researchers to the dubious rating practices of the leading CRAs. First and foremost, the leading CRAs bear a part of the responsibility for causing the subprime mortgage meltdown.3 They gave their highest ratings to novel mortgage-related securities that turned out to perform very poorly.4 In addition, the leading CRAs are accused of exacerbating the euro debt crisis by downgrading Greek bonds

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2 For convenience, this academic work refers to Moody’s, Standard & Poor’s and Fitch collectively as the “leading CRAs.”
Regulating credit rating agencies

just as European officials were about to unveil a support plan.\(^5\) The strong effect of rating announcements on the financial markets highlights the continuing reliance on leading CRAs despite their numerous shortcomings. Although the novel financial instruments that they were rating collapsed, the leading CRAs did not suffer much from the financial meltdown directly. Since their inception, CRAs have survived many financial crises regardless of their repeated rating inaccuracies. Surprisingly, they even become more powerful in the aftermath of financial debacles. From the perspective of the financial system, this gives rise to an unsustainable situation.

Given this context, financial regulatory reforms are the most important catalysts for change in the rating industry. CRA reforms have thus enjoyed a prominent place in regulatory efforts made in response to the 2007–2009 global financial crisis. Lawmakers and regulators around the world have concentrated on strengthening CRA oversight. In the United States (US), the Dodd-Frank Act of 2010 has acknowledged that CRAs should be regulated in the same way as other gatekeepers such as securities analysts and auditors.\(^6\) This US agency reform comprises the most sweeping regulatory intervention in the rating industry since its creation at the beginning of the twentieth century. In Europe, the absence of CRA regulation prior to the subprime mortgage crisis, and the general outcry with respect to their role in the financial crisis, put immense pressure on the European Union (EU) to adopt mandatory and enforceable rules in this field immediately.\(^7\) The EU CRA Regulation of 2009 has strived to respond to these concerns.\(^8\) In November 2010 the EU public consultation on CRAs was launched with a view to taking the

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second step toward regulating CRAs. Accordingly, the need to regulate the rating industry has increasingly been recognized worldwide.

The CRA reforms referred to above will partly address the problems in the credit rating industry. At any rate, a new era has begun in which lawmakers and regulators are aware of the importance of ratings in modern financial markets. They may aim to reduce the market dominance of the leading CRAs, yet have realized that they must take CRAs into account in their regulatory frameworks. CRAs are a part of the international financial architecture. The road ahead will provide challenges in regulating the rating industry and simultaneously decrease market over-reliance on the leading CRAs. As soon as the trend toward the decreasing use of ratings in regulations is successfully implemented in the financial markets, the role of CRAs will have to be newly defined. Not all problems can be solved instantly through financial regulatory reforms.

As a consequence, the CRA topic presents an interesting agenda for research. Before the global 2007–2009 financial crisis, insufficient academic attention was paid to CRAs despite their crucial place in the financial markets. Little academic research has been carried out in assessing the CRA regulatory framework and its impact on competition among CRAs. Scholars have repeatedly pointed out the need to remove rating-based regulations, yet little research has demonstrated the repercussions of such measures on the rating industry. Scholars have already written about the lack of supervision of CRAs, yet little research has shown how the rating industry will evolve in the aftermath of regulatory intervention. The ongoing period represents without doubt a time of significant change in the rating industry. There is extreme uncertainty with respect to the future development of CRAs. This academic research focuses on the interaction between regulatory intervention and competitive incentives among leading CRAs. Although CRAs are required to abandon their quasi-regulatory function, no academic consensus exists with respect to the necessity of competitive incentives in the rating industry.

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9 EU Commission, ‘Public consultation on credit rating agencies’ (November 5, 2010).
1.2 EVOLVING ROLE OF CREDIT RATING AGENCIES IN MODERN FINANCIAL MARKETS

CRAs assess the creditworthiness of borrowers and debt instruments by attributing different grades to them. The three leading CRAs in the world – Moody’s, Standard & Poor’s and Fitch – are essentially based in the US, yet they operate worldwide through subsidiaries established in many countries and their credit ratings are widely used around the globe. European lawmakers, regulators and market participants may wonder how it came about that this small number of American CRAs plays such a significant role in their affairs. Among other things this study strives to analyze this phenomenon of modern financial markets.

Ratings are of interest to investors and financial institutions as well as regulators. Financial markets need institutions that facilitate information intermediation; CRAs traditionally perform this function. Ratings are generally considered to be opinions or judgments about the creditworthiness of borrowers or debt instruments, but are not untestable assertions in the sense that CRAs’ performance can be measured ex post. Further, CRAs measure only credit risk and leave the other components of risk in the hands of investors’ own due diligence.

The functions performed by the leading CRAs are assessed in the light of the use of their ratings in modern financial markets. As information intermediaries, CRAs help link borrowers and investors. They provide investors with useful information for decision-making. Over the last few decades, investors and issuers have increasingly attached importance to the ratings of the leading CRAs. The globalization of finance, the

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12 EU Commission, ‘Staff Working Document accompanying the Proposal for a Regulation on credit rating agencies, Impact Assessment’ COM (2008) 704, 9–10 (stating that the three leading CRAs have their head office and main management, administrative and supervisory bodies in the US; nevertheless, they operate in the EU through subsidiaries).
13 Abdelal, Capital Rules (n 10) 166 (taking into account Moody’s and Standard & Poor’s as the dominant CRAs; the author considers the chances of Fitch displacing the two biggest ones as slim).
15 ibid 157.
increase of issuers and the complexity of new financial instruments imply an increasing role for CRAs given the lack of any alternative capital market overview. In modern financial markets it is almost impossible to initiate public offerings without issues being rated by the leading CRAs. The rating of novel financial instruments over the last four decades has resulted in the leading CRAs appearing to be more profitable than ever before.

However, CRAs are considered to have been one of the culprits in recent financial debacles. It is surprising that CRAs became so powerful despite their shortcomings. The main argument against CRAs is their inaccurate ratings. For instance, the subprime mortgage crisis has shed light on troubles resulting from dealing inconsistently with asymmetric information in the financial markets. First, CRAs were hired by issuers to help enhance the liquidity and marketability of novel financial instruments such as residential Mortgage-Backed Securities (RMBS) and Collateral Debt Obligations (CDOs). The favorable ratings of the leading CRAs were crucial for investor acceptance of these complex financial instruments. However, when the housing bubble burst in 2007, evidence showed that price discovery mechanisms failed to work and that the price of mortgage-related securities was not driven by the private market forces of supply and demand. Confidence shriveled up when investors realized that the ratings were inaccurate but that they were left with no other independent means of valuing the complex securities they were buying. In a very short period of time the subprime mortgage market became illiquid and collapsed. In fact, buyers could not discern between good and

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18 See, eg, SEC, ‘Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets’ (n 16) 19, 27–29 (discussing the importance of ratings in modern financial markets).
19 Hunt, ‘Credit Rating Agencies’ (n 14) 119.

Despite the massive dislocation associated with the recent financial crisis and the abysmal performance of CRAs, market participants have continued to rely on ratings.\footnote{Frank Partnoy, ‘Overdependence on Credit Ratings was a Primary Cause of the Crisis’ (2009) University of San Diego Legal Studies Research Paper Series No 09-015, 10. See also David Gillen, ‘In Ratings Agencies, Investors Still Trust’ The New York Times, June 5, 2009.} This gives rise to concerns about the role of ratings and the reason for leading CRAs’ success in the financial markets regardless of repeated scandals. Accordingly, scholars have written about the paradox of ratings.\footnote{Frank Partnoy, ‘The Paradox of Credit Ratings’ in Richard M Levich, Giovanni Majnoni and Carmen M Reinhart (eds), Ratings, Rating Agencies and the Global Financial System (Kluwer Academic Publishers 2002) 65–84; Schwarcz, ‘Private Ordering of Public Markets’ (n 11) 1–27.} Although CRAs were heavily criticized in the recent financial crises, hitherto little change has occurred with respect to their rating practices. CRAs have succeeded in imposing their presence and are considered to be indispensable entities to which many market participants refer when making decisions.

The best explanation of the paradox of ratings arises out of the significant use of ratings in financial market regulations.\footnote{Frank Partnoy, ‘The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies’ (1999) 77 Washington University Law Quarterly 619, 681–707 (already discussing the negative effects of rating-based regulations on the financial system in 1999; significantly, Professor Partnoy suggested removing regulatory references to ratings from regulations almost a decade before lawmakers and regulators began to take the problem seriously).} CRAs became private-sector entities with a quasi-governmental function.\footnote{‘Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the Senate Committee on Governmental Affairs’ (2002) 107th Congress, S Hrg 107-471 (opening statement of Joseph I Lieberman, Chairman, Committee on Governmental Affairs) 1. See also Susan Emmenegger, ‘Die Regulierung von Rating-Agenturen’ [2006] Swiss Review of Business and Financial Market Law 32, 41.} They could not have become as profitable solely by responding to the needs of the market for information. The rating market has gained in importance in modern financial markets for other reasons, especially regulatory concerns. Indeed, rating-based regulations have artificially increased the role of the leading CRAs in the financial markets. Issuers tend to hire CRAs


\footnote{22 Frank Partnoy, ‘Overdependence on Credit Ratings was a Primary Cause of the Crisis’ (2009) University of San Diego Legal Studies Research Paper Series No 09-015, 10. See also David Gillen, ‘In Ratings Agencies, Investors Still Trust’ The New York Times, June 5, 2009.}


\footnote{24 Frank Partnoy, ‘The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies’ (1999) 77 Washington University Law Quarterly 619, 681–707 (already discussing the negative effects of rating-based regulations on the financial system in 1999; significantly, Professor Partnoy suggested removing regulatory references to ratings from regulations almost a decade before lawmakers and regulators began to take the problem seriously).}

because favorable ratings give them a regulatory privilege.\textsuperscript{26} Although ratings do not serve investors’ needs satisfactorily, the leading CRAs became very profitable by serving issuers’ needs. Therefore, the core of the problem lies in the tension between the CRA business model and the use of ratings as a regulatory tool.\textsuperscript{27}

This study proceeds on the assumption that a successful reform of the rating industry must be accompanied by the withdrawal of rating-based regulations. In a competitive environment, CRAs’ revenues should directly relate to the substantive value of their ratings and not to any regulatory privilege.

Accordingly, the Dodd-Frank Act of 2010 marks a turning point by requiring the complete removal of regulatory references to ratings.\textsuperscript{28} Financial regulatory reforms will undoubtedly have an impact on the role of ratings in modern financial markets. In the long term, the new regulatory structure is expected to resolve the paradox of ratings. Therefore, the question arises as to what extent the role of CRAs will evolve in the near future pursuant to the implementation of the financial regulatory reforms.

### 1.3 RESEARCH SCOPE AND PERSPECTIVES

This study aims to analyze the competitive environment in the credit rating industry in the light of regulatory intervention. Focus is put on assessing the functions performed by the leading CRAs in the light of the use of their ratings in modern financial markets.

The research is done from the perspective of a legal researcher. Given the fact that this is an academic work, particular attention is paid to financial market regulations and the structure of the regulatory system. The two regulatory frameworks that are analyzed are the US and the EU regulations on CRAs. This study focuses mainly on the recent post-crisis reforms. Understanding the incentives of market participants – such as CRAs, investors and issuers – also plays an important role. Legal and economic aspects are therefore simultaneously taken into account in


\textsuperscript{27} ‘Taming the Beast, How Far Should Finance Be Re-regulated?’ The Economist, October 11, 2008, 6–16.

\textsuperscript{28} Dodd-Frank Act, Sec 939–939A.
order to assess the adequacy of the regulatory framework for CRAs. Further, the rating industry is considered from a critical perspective since recent rating scandals have tarnished the reputation of the three leading CRAs.

From a structural perspective, the new regulatory trends are moving toward incentive-based regulations. Market participants do not only concentrate their efforts on complying with the regulations, they also consider them a tool to gain an advantage over other market participants. It is thus important to analyze the interplay of market forces and regulatory incentives. Accordingly, regulatory failure follows when financial market regulations create wrong incentives, thereby distorting competition in the rating industry.

It is worth referring to the place of CRAs in the international financial architecture. Hence this study only analyzes regulatory aspects that are relevant with respect to the global financial markets. CRAs and their regulations are considered as a piece of the financial puzzle. A variety of regulatory requirements may affect the rating industry; at the same time, reforming CRAs may affect certain aspects of the financial system. The rationale is that CRAs deal with financial information. Access to ratings as financial information has an influence on regulators and market participants; CRAs’ access to information also plays a role in explaining their business models.

With respect to CRAs, the significance of US financial regulations around the globe is a result of the widespread importance of US-based CRAs. Above all, the Basel II Accord contributed to the increasing use of ratings for regulatory purposes on the global scale. Although this aspect of Basel II was heavily criticized in the 2007–2009 financial crisis, Basel III has not yet fully reformed the regulatory use of ratings. In addition, oversight of the US-based CRAs is associated to a large degree with US regulations. For instance, Swiss lawmakers and regulators have not

29 Abdelal, Capital Rules (n 10) 165.
followed the regulatory trend of establishing CRA oversight, preferring to leave the responsibility to the home regulators of the leading CRAs, i.e., mainly US regulators. Moody’s, Standard & Poor’s and Fitch exert their Swiss business from their US headquarters or through their European subsidiaries in Frankfurt or London. Nevertheless, the ratings of the three leading CRAs are crucial for Swiss regulators mainly because of the Basel framework. The Swiss financial market authority may only influence the leading CRAs by assessing whether they meet the conditions so that Switzerland uses their ratings for regulatory purposes. Therefore, this example illustrates the importance of US regulations on CRAs worldwide.

Broadly speaking, troubles in the rating industry arose out of the regulatory use of CRAs as private-sector entities. The Dodd-Frank Act of 2010 has implicitly recognized that rating-based regulations are inconsistent with the proper functioning of market forces in the rating industry. Without mentioning competition as an objective, the Dodd-Frank Act has acknowledged that the rating industry should be subject to private market forces; indeed, its CRA reform removes references to ratings from financial market regulations. Therefore, this study proceeds on the assumption that the market for ratings should become more competitive in the future.

1.4 OUTLINE

This academic work proceeds as follows:

Part 1 provides a description of the credit rating industry. An historical overview of CRAs illustrates how these entities became profitable and how their role has evolved since their inception. Further, CRAs are defined in terms of their core activities, the rating process and the main uses to which their ratings are put.
Part 2 discusses the regulatory context of credit ratings. Here the focus is on the structural aspects that have an impact on the financial markets. The regulatory structure creates incentives and is responsible for the functioning of market forces. On the one hand, regulators have initiated a trend to move away from rating-based regulations. CRAs will have to abandon their quasi-governmental function, thereby contenting themselves with their position of private-sector entities. On the other hand, new regulations have improved the oversight of CRAs by enhancing the supervisory framework. Regulations have also increased CRAs’ accountability by making them liable for their misconduct.

Part 3 focuses on structured finance ratings. This topic has gained prominence due to the subprime mortgage crisis. The leading CRAs have played a crucial role in the growth and design of novel financial products. Criticism has been raised about the creation of wrong incentives in the rating industry, thereby distorting competition. In particular, the structured finance ratings segment is subject to severe conflicts of interest that jeopardize the independence of the leading CRAs. This study presents the newly enacted regulatory provisions that aim to reform the structured finance segment.

Part 4 analyzes the systemic importance of credit ratings. Interest in this topic has increased in the light of the downgrades of sovereign ratings and the euro debt crisis. System-relevance emerges from market over-reliance on a concentrated rating industry, giving the leading CRAs excessive market power. As a consequence, financial markets are to some extent characterized by a homogenization of financial information and of market behavior. Market over-reliance on the leading CRAs results in a reluctance to downgrade ratings given the spillover effects of rating announcements. Accordingly, this situation jeopardizes the independence of the leading CRAs because they have to take the repercussions of their ratings into account prior to downgrading. This study analyzes the recent regulatory trends in order to explain how to move away from the systemic relevance of ratings.

Part 5 concludes the study. A number of regulatory amendments concentrate on restoring competition in the rating industry. This study favors sector-specific regulation as compared to antitrust intervention. The key to reforms consists of creating better incentives in the rating industry. In particular, investors should perform their own due diligence, regulators should enhance disclosure requirements and find substitutes to the use of ratings for regulatory purposes.