Dipartimento di Economia E Finanza, Cattedra di Financial Markets Law and Regulation. Corso di Laurea “ Financial Economics”

“THE EUROPEAN REGULATION OF CREDI RATING AGENCIES”

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CONTENTS

Sommario

INTRODUCTION

Credit rating agencies are independent providers of credit opinions . Their main business is analysing business or governmental information and then issuing an opinion on the creditworthiness of a company, a government or other financial debt instrument. This opinion, called ratings, are closely expected by various operators in the market such as investors, governments, borrowers and issuers.

For the last 20 years, Credit Rating Agencies (CRAs) have been playing an increasing key role on financial markets. Issuers and investors depend both on the information created by CRAs helpful to determine the financing cost and afterwards could influence buying and selling decisions.

The growing importance and influence of this agencies can be explained by ;

- the increase size and structure of financial markets participants;
- the shift of credit’s supply from banks to capital markets;
- the continuous creation of new and often complex financial products;
- the complexity and diversity of investment strategies of these participants;
- increased reliance of sovereigns on bond financing; and,
- finally, the fact that actors in the market are offered a time-saving and comparative tool to evaluate the growing number of debt issues.

Credit ratings are firstly important for issuers. This is important for them because a rating most certainly will influence the costs of the capital (the interest rates they will have to pay for the capital raised). A good rating will improve also the marketability of their product.

Secondly, investors such as insurance companies, pension funds but also mutual funds, are substantial users of credit ratings. They have to know what kind of risk, what level of risk they are assuming. Besides that they can also use these ratings next to their own internal credit assessments and investment analyses in order to make proper and well informed investment decisions.

Thirdly, also a credit institution can be interested in a rating because they are entitled to use ratings for the calculation of their capital requirements according to the financial regulation actually in force. Broker-dealers also make use of credit ratings. They rely on ratings themselves when they act as issuers of debt, but also use and rely on ratings when they assist issuers in finding an appropriate rating agency or just only for selling purposes. Credit ratings reduce uncertainty for these parties. Alongside with the importance for these actors, ratings are also important for regulatory use and are often used in private contracts.

The European Commission described two general reasons why credit ratings are of great importance at least for the European market. One of them is the regulatory tool, the other one is reduction of the information asymmetry. Beyond that , rating agencies provide for the mitigation of the information asymmetry and also offer a tool for solving principal-agent and collective action problems.

Credit Rating Agencies (CRAs) exist since the 19th century, but they made their path undisturbed and without the attention of regulators and legal doctrine, despite the increasing importance they have had in financial markets development during the 20th century. The first detailed regulatory intervention has occurred in the early years of the 21st century following the corporate scandals that upset financial market, hereafter leading to default of famous companies. The CRAs then showed not to be able to predict those defaults and so to fail his main task.

The role of CRAs getting worse the financial crisis, has become startlingly clear in the subprime financial meltdown, and yet investors and the financial press still discuss ratings widely.

Business and conflicts of interest have led to an inflation of ratings and a deterioration in their quality. Thus, it would appear that CRAs need strict supervision. While certainly burdensome and likely to raise barriers of entry, the European regulation seems to be the most sensible solution. Market discipline based on competition and transparency as envisioned in the US lead to a weak surveillance regime, while leaving the regulatory license intact.

In the US the effect of this loss of reliability in CRAs ratings resulted in a new regulation based on the Credit Rating Agencies Reform Act of 2006 and the Securities Exchange Commission (SEC). Almost in the same period also Basel II Accord was issued, which fixed some basic rules about Banks' capital requirements, including many provisions concerning CRAs that attributed them a crucial role in the evaluation of banks assets and then in the determination of the capital requirement itself. Moreover, Basel II Accord and its implementation by the Capital Requirement Directive, has introduced for the first time within European Union, a core of rules concerning rating agencies. The purpose of this paper is to provide an overview on how CRAs are currently regulated under EU law, and to emphasize how, regardless of national systems or legal traditions, such regulations tend to show the same weakness and to raise the same issues. In fact, all of the examined sets of rules seem on one side to create a very profitable market for the CRAs, but on the other side to favour through certain appointment requirements the agencies who already own big shares of the rating market, avoiding then to promote an actual competition. Finally, we briefly examine the rules that have recently been proposed both in US and EU in response to the current financial crisis, in order to spotlight their most prominent innovations and to attempt to trace the ongoing trends in rating market regulation.

1 CREDIT AGENCIES AND CREDIT RATING AGENCIES

What are the Credit Rating Agencies? A possible answer comes from the official definitions given by the most important legal bodies. It is defined by the European legislator in *article 3.1.(b) of Regulation 1060/2009* as:

"a *legal person whose occupation includes the issuing of credit ratings on a professional basis"*.[1]

With the Credit Rating Agency Reform Act of 2006, the U.S. legislator has created a slightly different definition and especially more detailed. According to American law a credit rating agency is described as:

"any person - ''(A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; ''(B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and ''(C) receiving fees from either issuers, investors, or other market participants, or a combination thereof"[2].

This definition is far narrower and more precise. It contains certain eligibility requirements that cannot be found in the European definition. It is broader in the sense however that it in theory could also cover any natural person where the European definition only covers a legal person.[3] This if of course not what is meant.

The International Organization of Securities Commissions (IOSCO) finally describes a credit rating agency as:

"those entities whose business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities."

This definition comes relatively close to, and can be compared with the European definition. On the other hand a credit rating is defined by both the IOSCO and the European Committee of European Securities Regulators (CESR), now the European Securities and Markets Authority (ESMA), as:

"an opinion regarding the creditworthiness of an entity, a credit commitment, a debt of debt-like security or an issuer of such obligations, expressed using an established

[1] Regulation (EC) No. 1060/2009 of the European Parliament of the council of 16 September 2009, L302/9
[2] Credit Rating Agencies Reform Act of 2006, 15 USCS § 78c
[3] Committee of European Securities Regulators, *Technical advice to the*
European Commission on the equivalence between the US regulatory and supervisory
framework and the EU regulatory regime for credit rating agencies, CESR/10-332, 21-05- 2010, p. 56 and 57.

and defined ranking system. Credit ratings are not recommendations to purchase or sell any security". [4]

In its turn, the Credit Rating Agency Reform Act defines a "credit rating" as:

"an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments"[5].

Although the definitions are not completely equal they do refer to the same activities performed by the same companies. The fact that most of the rating agencies look alike is not new, but to which extent can they be treated as other financial actors such as banks and accountancy firms? Partnoy agrees with Coffee and others that credit rating agencies belong within the classification of financial market „gatekeepers".[6]

Gatekeepers can be described as:

"*reputational intermediaries who provide verification and certification services to investors*"[7]

However does state that credit rating agencies differ from other gatekeepers for the following reasons. Rating agencies are more profitable than other gatekeepers, they face different and potentially more serious conflicts of interests and they are like no other active in structured finance activities[8]. The reason why credit rating agencies are different from other gatekeepers when it comes to conflicts of interests is caused by the fact that rating agencies are directly paid by the issuers that they rate, but also because the majority of revenues of credit rating agencies are derived from the fees paid by issuers. Combined with the ancillary services provided by rating agencies that cannot be developed by other gatekeepers, at least in a way that rating agencies do, makes that rating agencies can be labelled as different at least with regard to conflicts of interest. The arguments that Partnoy uses underline perhaps even more

[4] Code of Conduct Fundamentals for Credit Rating Agencies, OICV – IOSCO, December 2004, p. 3.
[5] Credit Rating Agency Reform Act, section 3.
[6] Partnoy 2006, p. 59.
[7] J.C. Coffee, *What Caused Enron?: A Capsule Social and Economic History of the 1990's,* Columbia Law and Economics Working Paper No. 214, January 2003, p. 13.
[8] Partnoy 2006, p. 62.

that credit rating agencies should be seen as gatekeepers and should be treated that way as well. Rating agencies however prefer not to be seen as gatekeepers but more as publishing. This has of course something to do with the liability discussion, where rating agencies at the moment are not subject to[9]. Besides that they do not want to be subject to more and stricter legislation in the future.

1.1 The History of Rating Agencies

The present-day credit rating industry has a long history, beginning in the 19th century with financial publishing. The Mercantile Agency, one of the first credit reporting agencies, was founded 1837 by Louis Tappan in New York . It used for its purpose, a network of agents to collect information on business standing, operating statistics, and creditworthiness on businesses. Then spread this information to subscribers. In 1909, at the turn of the 20th century, the first CRA - as we know them today – was established by John Moody to rate U.S. railroad bonds. He began collecting financial and operating statistics on the railroad bond market and selling information. This information collection included an analysis of the quality of a business's portfolio (a portfolio composed by a set of different opportunities) and the management's success in pursuing these opportunities, its ability to respect debt obligations, and its tendency to honour debts. Lastly this information was used to estimate the risk associated to each corporate debt. The predecessors of S&P were founded in 1916 and 1922, respectively. Fitch publishing company started its operations in 1924.. Langohr and Langohr argue that the expansion of the credit rating industry formed an information infrastructure necessary for bond markets to expand throughout the 20th century.

During the Great Depression, John Moody's and Henry Poor's credit rating firms had a positive performance. In a period in which the companies had a high probability of default, then associated to high interest rates of their bonds, high rated bonds became more attractive. It is necessary add that regulators in the United States

[9] Partnoy 2006, p. 83.

were in need of a credible point of reference, which was found in credit ratings .This reinforced these companies' reputations for reliability and accuracy . Between World War II and the 1970s, the financial markets were relatively stable. For this reason, CRAs were only modestly profitable, their opinions were less required, given the absence of big innovations and turbulences. Major structural turning point took was during the latter part of the 1960s and the 1970s, as market-based corporate funding became more common and the demand for ratings increased rapidly. This task is usually assigned to the banks and rating agencies. Both in fact compete in the provision of analysis of creditworthiness. The interest of the commercial banks is mostly facing to substantive analysis of loans (usually held in their balance sheets). A the same time, the work of rating agencies is more related with the issuance of marketable debt instruments. As inflation began to increase in the late 1960s and 1970s, commercial banks and thrifts found it increasingly difficult to raise deposits because of the specific legal limit. In fact under Regulation Q, is well defined what could and could not pay the depositaries. The extension of Regulation Q to savings and loans in 1966 further restricted the ability of traditional lenders to provide credit. Other entities, such as mutual funds, realized that they could play an even more prominent in the provision of credit. It returned so useful the services performed by the rating agencies. Therefore it was required a growing infrastructure able to rate the creditworthiness of the debts (even of the banks' debts).

The first market segment to take advance from this transition was business lending. While railroad bonds had served as the catalyst for the growth of the U.S. corporate bond market, until the 1960s other nonfinancial industries still relied on traditional methods. Banks or internal funding was used to finance their investments. The nonfinancial commercial paper market tripled in size between 1975 and 1980.[10] The longer-maturity corporate bond market grew by 80 percent. It is easy to understand that with the growth of this structured finance market, grew as well the demand of ratings. Then the boom of the U.S. residential mortgage-backed securities

[10] Federal Reserve, Federal Reserve Board Flow of Funds, 2011: Washington DC

and home-equity loan markets rapidly increased the structured finance market. From the 1980s, globalization played a huge role as well. Credit ratings agencies started to expand beyond the United States. United Kingdom, Japan, France, Australia, Canada, India, Sweden, Russia, Mexico, and Australia.

Thus, globalization and the introduction of new financial products to be rated drove greater demand for CRA products and accounted for a large share of CRAs' profitability. [11]

In response to changes in the marketplace, in 1974 Standard and Poor's shifted its business model and began charging issuers for ratings rather than charging a subscription service to investors. This change from user pays to issuer pays is considered another important moment, which contributed to reduced credibility in rating agencies. The 1970 Penn Central default on $82 million in commercial paper, followed by liquidity crises, also refocused attention on the importance of credit risk. As issuers wanted to assure investors of quality ratings, they began actively seeking out ratings. As market demand for ratings shifted, CRAs began charging issuers rather than investors.[12] During the same years the SEC introduced the NRSRO designation and incorporated it into regulations.

1.1.2 Main Players

1. Moody's Investors Service, Inc.

Moody's is the only one of the major CRAs that is a freestanding, publicly traded company. It was previously a division of Dun & Bradstreet (which absorbed Moody's in an acquisition in 1962) but was spun off as a freestanding company in 2000. As of 2011, almost 70% its revenues are derived from ratings. In calendar year 2011, Moody's had aggregate sales of $2.3 billion, assets of $2.9 billion, and

[11] Apgar, P.E., D. Arthur, and L. Monaco, Moody's, Equity Research Report, M. Stanley, Editor 2005, Morgan Stanley: New York City. p. 1-16.
Crockett, B., J. Jowe, and F. Searby, Moody's attractive business, but growth hiatus in 2004, N.A.E.R. JPMorgan, Editor 2003, North American Equity Research: JPMorgan: New York City. p. 1-44.
[12] White, L.J., The Credit Rating Industry: An Industrial Organization Analysis, in Rating Agencies in the Global Financial System2001: NYU Stern School of Business.

profits ("operating income") of $0.9 billion, and its employees numbered approximately 6,500. Moody's is an international company; it has offices in 28 countries, and it provides ratings for issuers that are located in 110 countries. In 2011, 56% of its rating revenues came from ratings of U.S. issuers; the remaining 44% came from ratings of issuers that were located outside the U.S.

As part of the regulatory regime that was created by the Credit Rating Agency Reform Act (CRARA) of 2006, certified CRAs are required annually to file data with the SEC that specifically describe their global rating activities. Moody's maintained ratings on almost a million bond issues in 2011, with its analysts and supervisors numbering around 1,250. Among the reasons why the ratio of bond issues to personnel can be so high is that some issuers – such as governments – issue many different series of bonds; but the credit rating is essentially on the issuer, so that the single rating covers multiple issuances. [13]

B. Standard & Poor's Ratings Services.

The rating business of S&P is embedded in the larger S&P financial information enterprise, which (among other things) compiles and publishes financial instrument indexes (such as the "S&P 500" index). S&P, in turn is part of the McGraw Hill Companies, which is a major textbook publisher and business book publisher. Because S&P's ratings activities are embedded in the much larger McGraw-Hill corporate structure, much less financial information has been available about S&P ratings as a standalone unit. In 2011, S&P's ratings unit had aggregate revenues of $1.8 billion. Like Moody's, S&P Ratings has a major international presence, with offices in over 20 countries. Of its 2011 revenues, slightly more than half (51.5%) came from U.S. sources; the remainder came from abroad.

From S&P's Form NRSRO for 2011 it is possible observe that S&P is approximately the same size as Moody's in terms of ratings outstanding and rating personnel.

C. Fitch Ratings.

[13] These data are summarized in USSEC (2012b; 2012c)

Fitch Ratings is part of the Fitch Group (a financial information company), which in turn is a jointly owned subsidiary of a French financial services company (Fimalac, S.A.) and the Hearst Corp. Consequently, as is true of S&P Ratings, there is little financial information about Fitch Ratings as a freestanding entity. In 2011 Fitch's revenues from ratings came to $732 million. Fitch is somewhat more internationally focused than are the other two major CRAs. Of its 2010 revenues, only 41.9% came from North American sources.

From Fitch's Form NRSRO for 2011 , it can be seen that Fitch is roughly a third of the size of Moody's or S&P when the metric is ratings outstanding, although Fitch has only a modestly smaller number of rating personnel.

1.2 The History of Credit Rating Agency Regulation

While the financial markets were changing and structured finance grew, government regulators also played a key role in this industry. At the beginning European Regulators did not seek to regulate CRAs directly, they though rating agencies was a tool to oversee the financial markets. Since the success of a rating agency is based on its reputation, and as well reputation is based on the degree of freedom of its ratings, the idea was that the market was able to self-regulate this growing business field. This approach was denominated as "self-regulation". Securities and Exchange Commission regulators wrote many rules that specifically identified CRAs, thereby indirectly creating a regulatory framework reliant on CRAs[14]. The first set of regulations involving credit rating agencies went into effect after the onset of the banking crisis in March 1931. Banks were in need of greater liquidity following the onset of the Great Depression, and so they dumped their lower grade bonds on the market, which contributed to the overall decline in bond prices. This lower valuation of bonds reduced the market value of bank's bond portfolios overall and contributed to bank failures, demonstrating that bond values, rather than simply defaults, also

[14] Emily McClintock Ekins and Mark A. Calabria. Regulation, Market Structure, and Role of the Credit Rating Agencies , Policy Analysis n.704 2012.

mattered to bank survival[15]. This relationship between the rating agencies and the U.S. bond markets changed in 1936 when the Office of the Comptroller of the Currency prohibited banks from investing in "speculative investment securities," as determined by "recognized rating manuals" (i.e., Moody's, Poor's, Standard, and Fitch). "Speculative" securities were bonds that were below "investment grade[16]," thereby forcing banks that invested in bonds to hold only those bonds that were rated highly by these agencies. Furthermore, the Office of the Comptroller of the Currency (OCC) set out to regulate banks' capital reserves with the hopes of preventing future bank failures. The OCC set minimum capital reserve requirements to ensure banks did not become overleveraged. In the following decades, insurance and then pension fund regulators followed with similar regulatory actions. To ensure compliance with the new regulations, the OCC needed some outside body to evaluate the risk. Credit ratings helped the OCC conduct a valuation of national bank bond portfolios, and the OCC provided incentives for investments highly rated by a CRA, increasing demand for ratings. The comptroller stipulated that national banks would not be required to charge off depreciation to market value on bonds receiving one of the four highest ratings. [17]This meant that publically traded bonds rated BBB or higher by at least one CRA could be valued at book value[18]. In 1936, the OCC and the Federal Reserve directed that banks not hold bonds rated below BBB by at least two credit rating agencies. These rules introduced CRAs into the financial regulatory framework. The role of the CRA's becomes necessary and not merely ancillary.

In the late 1960s, a considerable increase in volume on the New York Stock Exchange overwhelmed the mechanisms that brokers used to transfer securities. This, combined with a subsequent trading volume decline, drove nearly 100

[15] Friedman, M. and A.J. Schwartz, A Monetary History of the United States 1867- 19601963, Princeton: Princeton University Press

[16] United States Comptroller of the Currency, Purchase of Investment Securities, and Further Defining the Term "Investment Securities" as Used in Section 5136 of the Revised Statutes as Amended by the "Banking Act of 1935," Section II (February 15, 1936). This rule still applies to banks today.

[17] Friedman, M. and A.J. Schwartz, A Monetary History of the United States 1867- 19601963, Princeton: Princeton University Press.

[18] Langohr, H. and P. Langohr, The Rating Agencies and their Credit Ratings: What They Are, How They Work, And Why They Are Relevant2008, West Sussex: Wiley Finance.

brokerage firms out of business.[19] The SEC later decided to enforce more stringent capital requirements to stop this excessive liquidity. Consequently, the SEC adopted another wave of banking regulation, beginning in 1973, with a uniform net capital rule. Frist the Net Capital Rule for broker-dealers (Rule 15c3-1), intended to ensure "*that registered broker-dealers have adequate liquid assets to meet their obligations to their investors and creditors*."[20] To make capital requirements sensitive to the riskiness of broker-dealers' bond portfolios, the SEC decided to use the ratings on those bonds as the indicators of risk as a relevant source for evaluations of the bond portfolios risk grade. However, the SEC worried that references to "recognized rating manuals" were too ambiguous and subject to fraud. If a broker-dealer claimed that those ratings were "recognized," the SEC might have difficulties challenging this assertion. This established a new designation for select credit rating agencies called the Nationally Recognized Statistical Rating Organization.

The SEC instituted the NRSRO designation to ensure that bank issuers would not simply find credit rating agencies whose only purpose was to deliver high ratings on financial instruments. Not all credit rating agencies were bestowed the NRSRO designation. Hence, the SEC designated Moody's, S&P, and Fitch as "Nationally Recognized Statistical Rating Organizations" (NRSROs). [21] These companies were selected because of their previous record of accurate ratings. In this way, the SEC endorsed the ratings of NRSROs for the determination of the broker-dealers' capital requirements. This was intended to safeguard broker-dealer proprietary securities from price fluctuation risks. Obtaining investment-grade ratings from at least two NRSROs reduced the requirement of deducting particular percentages of market value from the net worth of instruments. This incentivized broker-dealers to invest in higher NRSRO rated instruments because it translated into higher net capital. Obtaining a designation was not necessary for CRAs to operate, but this given them

[19]Jamroz, M.P., The Net Capital Rule. The Business Lawyer, 1991-1992. 47: p. 863-912.
[20] Jamroz, M.P., The Net Capital Rule. The Business Lawyer, 1991-1992. 47: p. 863-912
[21] "Commodity and Securities Exchanges," Title 17, *Code of Federal Regulations*, section 240.15c3-1 (1998). Also, in the early 1990s, the SEC again made use of the NRSROs' ratings when it established safety requirements for the short-term bonds (e.g., commercial paper) that are held by money-market mutual funds.

a large advantage, especially for investors (including both public and private pension funds, insurance companies) were legally mandated to purchase investments highly rated by NRSROs. Moreover, other investors were also incentivized to purchase investments highly rated by NRSRO CRAs to obtain regulatory benefits.

The SEC did not grant many NRSRO designations, and those companies for which they did often merged, keeping the total number of NRSRO CRAs to about three to four. Mergers quickly brought the number of CRAs down to three by the turn of the millennium. Day by day, regulators became increasingly dependent on NRSRO ratings, and as Langohr and Langohr argue, "the use of ratings in regulations is most widespread in . . .the U.S." In fact, by June of 2005, there were at least 8 federal statues, 47 federal rules, and 100 state laws referencing credit ratings issued by NRSRO CRAs. [22] CRAs came under fire in the early 21st century with the implosion of Enron, WorldCom, and Parmalat. The dominant CRAs gave most of these companies' bonds investment-grade ratings but a few days or months they declared bankruptcy. This facts and all the events linked with the European sovereign debt crisis later, brought US and Europe to overhaul their own legislation.

1.3 Rating Type

Credit rating agencies are privately owned companies that assign a credit rating or rating services to debt issuers such as; companies, financial institutions, insurance companies, sovereign states, sovereign-supported entities and supranational issuers Can be assessed and rated also their own debt instruments/securities such as loans, bonds, convertible bonds and structured finance securities . Credit rating agencies can operate on a regional, national or even international level. The European Commission divided ratings in four types in 2012: corporate ratings, structured finance ratings, sovereign and public finance ratings and covered bond ratings.[23] EU splits corporate ratings in:

[22] Langohr, H. and P. Langohr, The Rating Agencies and their Credit Ratings: What They Are, How They Work, And Why They Are Relevant2008, West Sussex: Wiley Finance.
[23] Commission Delegated Regulation (EU) No 446/2012 of 21 March 2012, L 140/3, Article 4.

- financial institutions including credit institutions and investment firms,
- insurance undertakings and
- corporate issuers that are not considered as a financial institution or an insurance undertaking[24].

Regarding the rating of structured finance products it is possible to further differentiate between ratings of asset-backed securities, residential mortgage-backed securities, commercial mortgage-backed securities, collateralized debt obligations, asset-backed commercial papers and other structured finance instruments. [25] A credit rating reflects a rating agency's opinion of, or perspective on the creditworthiness of a particular company, a financial instrument or obligation (as of a specific date).[26] CRA's offer to their users a wide range of ancillary services as the issuing of short-term credit opinions, industry-specific ratings and analysis, consultancy or advisory services (proposals or recommendations regarding the design of a structured finance instrument[27]) and the issuing of public statements.

1.4 Credit Assessment Methodology

"*A small number of CRAs use the model-driven approach, focusing on quantitative data that they incorporate into a mathematical model to produce their ratings. In analyst-driven system, credit rating professionals conduct a review of the financial performance, policies, and risk management strategies as well as of the business and economic environment in which the issuer operates. In addition to evaluating financial data, credit analysts typically weigh qualitative information*" (Standard & Poor's, 2013b).

Rating methodology refers to the methods, and processes that govern CRAs' application of criteria to a particular rating or practice (i.e. corporate, public finance, asset-backed securities). Rating methodology is designed to measure the

[24] Commission Delegated Regulation (EU) No 449/2012 of 21 March 2012, L 140/34, Article 5.
[25] Commission Delegated Regulation (EU) No 446/2012, Article 4
[26] U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market, January 2003, p. 5.
[27] Regulation (EC) No 1060/2009, under (22).

creditworthiness (or probability 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 with the purpose to design of a model is conceptually robust. 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. 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[28]. 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[29]. In addition to background data, forecasts, risk reports, or factual feedback on proposed analytical research and other communications. For instance, the sovereign rating methodology addresses the factors that affect a sovereign government's willingness and ability to pay back its debt fully and on time. Hence sovereign ratings are based on a range of quantitative and qualitative factors to determine this ability. Credit ratings are expressed in the form of a letter grades combination. The rating grades correspond to the CRA's criteria even if for every agency the value assigned to the same letter is not equal. As mentioned, Ratings are expressed as letter grades that range from 'AAA' to 'D' to communicate the agency's opinion of relative level of credit risk. 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). To clarify the "economic" meaning of each letter, below there is

[28] Standard & Poor's, 'Understanding Standard & Poor's Rating Definitions' (2010) accessed 5 March 2012, 6.
[29] Standard & Poor's, 'Guide to Credit Ratings Criteria. Why criteria are important and how they are applied' (n 84) 3

the translation used S&P's: (1) 'AAA', extremely strong capacity to meet financial commitments; (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 favorable 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 [30]. 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 modeling of the arbitrage equilibrium prices of an issuer's equity and assets, probability theories and empirical observations of past defaults[31]. 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. The Rating criteria reports have to 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). CRA's methodologies regard country-specific risks, industry and economic data (asset quality, funding, and profitability based primarily on data from the institution's

[30] Standard & Poor's, 'Guide to Credit Rating Essentials. What are credit ratings and how do they work?' (2011) 10.
[31] 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.

public financial statements and regulatory filings), historical and projected financial statements, history of defaults, management policies, and features of the specific financial product. 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 debt). However, in order to ensure integrity of the result, an internal organization is developed to revise and update the criteria assumed needs to be developed. 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, legal background, educational certificate, or degree qualification is required to be appointed as rating analysts. Andrew Fight observes that "rating analysts work for companies that put out opinions with disclaimers denying all responsibility for the accuracy contained within". And he continues "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".[32]

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. 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. It is possible qualify the ratings even according to the sources of the utilized information: (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

[32] See Andrew Fight, The Ratings Game (n 90) 4.

structures that are designed to honors 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)[33]. 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- 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.[34]. 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 [35]. Important studies carried by the Basel Committee highlighted that "analysis of a stylized 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 quantification techniques employed" [36]. The key element in credit risk models is the measure of the 'probability of default', but the exposure determined by the expected timing of default and by the 'recovery rate' after default has occurred has an important weight.[37] Rating methodologies evolve over time. they respond to a continuous adjustments given by new information and economic developments. These adjustments tend to be small

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

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

[35] 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 . IMF, 'The Uses and Abuses of Sovereign Credit Ratings' (n 4) 91.

[36] Basel Committee on Banking Supervision, 'Studies on the Validation of Internal Rating Systems' (2005) Working Papers No. 14, 2.

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

for several reason expressed in the next chapters. To conclude it is necessary to remember that the purpose of rating activities has to ensure transparency, disclosure of information, fairness and monitoring of their methodologies. All of this should be oriented to the investor perspective.

1.5 Users

There are a wild range of possible issuers, not only companies but also special purpose vehicles and banks (private entities), state and city governments, non-profit organizations, agencies and other public institutions can be debt issuers or issuers of financial instruments. Investors like credit institutions, investment firms, (re)insurance, assurance companies, undertakings for collective investment in transferable securities (UCITS) and institutions for occupational retirement provisions also rely on ratings when they make their investment and regulatory decisions.[38] In addition to financial analysts and financial intermediaries. When an issuer of a public bonds wants to sell quickly and at a profitable interest rate, it is advisable requiring a rating from one or more rating agencies. By obtaining the best rating possible, the cost of debt will be as low as possible, and the issuer will get an access to the capital market more efficient. An investor will demand a higher interest rate when the investment is more risky and an high-rated bond is perceived as more safe. Becker and Milbourn assess minimum three reasons why an issuer has profit from a rating. Firstly, it may improve the marketability or the pricing of their financial instrument, it secondly can increase the issue's trustworthiness and it finally may increase the selling process to investors with preferences over ratings. Besides these reasons it is also possible that a rating is obliged by regulation, which can be the case with institutional investors like banks, insurance companies and pension funds, when they need to make their investment decisions. Ratings are also used to identify or classify assets in financial statements. In fact they are mostly used also in legislation to determine capital requirements of institutions such as

[38] Regulation (EC) No 1060/2009, under (1).

banks and investment firms. Credit ratings can provide an evaluation of the credit risk associated with structured financial products.[39]

1.6 CRA Criticism and Ethics

With increasing market power of CRAs and the involvement in different regulatory frameworks of sovereign states and institutions, the criticisms changed from “operational” criticisms to a "systemic" critique of the rating system as a whole. A widely range of critiques came from different public institutions as the European Union, the OECD organization or the U.S. Congress, etc. which brought to turnabout in their each regulatory framework, naturally with different weights . Especially after Accounting scandals like Enron or Parmalat or the recent financial crisis of the 2008 or 2011 and ongoing European sovereign debt crisis, credit rating agencies are confronted with increasing critique. The OECD chief economist Pier Carlo Padoan said in an interview in 2011: "Lately, rating agencies have proved that they are strongly 'pro-cyclical' and produce self-realizing prophesies". Furthermore, Padoan said “(…) *the agencies did not merely pass on information but ‘express judgments’, speeding up trends already at work*."[40]61. It is necessary to analyse the several problems that came out especially in the critical last years. Here they are structured in in five main subjects:

1. Principal Agent / Issuer Pays (Conflict of Interest), Free-Rider Problem;
2. Regulatory Framework / Market Power;
3. Disclosure Practices;
4. Moral Hazard – Information asymmetry;
5. Latency in Rating Downgrades.

1.6.1 Conflict of Interest

[39] Becker, Milbourn 2011, p. 499.
[40] cf. EUBusiness 2011: http://www.eubusiness.com/news-eu/oecd-eurozonedebt.b5x, 14 Nov. 2011.

The salient conflict of interest confronting Moody's employees is that which arises simply from being employed by Moody's. This conflict of interest permeates all levels of employment, from entry-level analyst to the Chairman and Chief Executive Officer of Moody's Corporation. However, the nature of the conflict-of-interest differs by levels of employment. [41] William J. Harrington

Since the 1970s the business model changed from an "investor pays" to an "issuer pays" model and CRA's developed other sources of income. Several potential sources of conflicts came out, concerning the independence of credit rating agencies, that was discussed heavily and also had led to several investigations by the SEC in the US, the European Commission in Europe and other international institutions. For instance, the IOSCO stated in a 2003 report on the activities of CRA „(...) the single greatest concern facing CRAs is identifying and addressing potential and actual conflicts of interest that may inappropriately influence the rating process." [42]. Furthermore, in a 2003 report by the U.S. SEC required by the Sarbanes-Oxley Act recognized "(…) that the potential conflicts of interest faced by credit rating agencies have increased in recent years, particularly given the expansion of large credit rating agencies into ancillary advisory and other businesses, and the continued rise in importance of rating agencies in the U.S. securities markets."[43]. Then it outlines a triangle-relationship between investors, CRAs and issuers. The three possible relationships are investor-issuer, issuer-CRA and investor-CRA and all are subject to potential principal agent problems. Principal-Agent problems exist in relationships where the principal (investor) compensates the agent (CRA) for performing several services for the principal (Credit Rating). The issuer relies on a good credit rating by a CRA, to reduce his financing costs; this is one of the reason that drives companies to . On the other hand, the credit rating receive an income and the issuer became its customer. The dependence of CRAs on revenues as every company from issuers could lead to a more favourable behaviour. As said before the methodologies of each CRA's is different and almost secret and the discretional. As

[41] Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations File Number S7-18-11. 8/8/2011

[42] IOSEC 2003: 12

[43] SEC 2003: 40

regard the rating process, conflicts of interest can appear in different step of the rating process: at the initial contact between the issuer and the CRA, during the preparation of the rating and the discussion at the rating committee and most of all during the presentation to the client. An increasing conflict comes from the fact that rating-fees are based on the size of the issuance/issuer and therefore gives large enterprises the possibility to influence the results. Another source of important critics in regards to the conflict of interest problem related with ancillary businesses of CRAs. In the past 30 years, CRAs developed secondary sources of income such as assessment services, due diligence or consulting services and offer these services on the market. the conflict issue is if there is or not clear separation between the classical rating services and additional services sold. As these additional services are also offered to enterprises that are rated, critics argue that the decision of the issuer to purchase additional services or not may influence the rating decision and deflect from the CRAs primary role. The SEC recognizes this matter in its report by stating: *"(...) issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation that purchasing these services could help their credit rating)".*[44] Credit rating respond to this critiques that they have imposed strict internal regulations and have avoided any type of analyst compensation that could influence the rating decisions. Furthermore, CRAs argue that fees of even the largest enterprise customers have minor economic impact on a credit rating agency's total revenue. It is clear that credit rating agencies are public corporations that have to follow economic and financial constraints, and their aim is to maximize their own profits.

As said above there are also ratings not instructed by the issuer (unsolicited ratings for which issuer does not pay). Smaller rating agencies also tend to create unsolicited ratings in order to possibly increase market share or reputation. "If all securities are rated, an issuer cannot avoid ratings by not requesting them, and a self-selection process where only low credit risk issuers are rated cannot develop[45]." Unsolicited Ratings were criticized by international financial institutions such as the

[44] SEC 2003: 42
[45] Frost 2007: 17

Bank of International Settlement or the SEC in the U.S. in association with three fundamental problems that partly led to investigations concerning "abusive practices[46]": 1-In case of unsolicited ratings, credit rating agencies do not have complete insight in companies they rate and therefore the rating may be biased. CRAs have access to public information available and that financially weak corporations tend to avoid credit ratings, ; 2- Whereas in case of instructed ratings, the issuer has the possibility to discuss the rating, unsolicited rated companies don't have this possibility; 3- Some critics argue that credit rating agency use unsolicited ratings to induce issuers to pay for ratings (and hence increase the credit rating)[47]. Since CRAs is obliged to contact issuers who did not pay for their ratings before the publication of the results.

1.6.2 Regulatory Framework and Market Power.

In 2009 the SEC reported that 97% of all outstanding ratings across all categories were issued by the three U.S. CRAs. This high concentration of market power is discussed heavily in literature and "(…) leaves some wondering if credit ratings are a natural oligopoly (…)"[48]. Since several different regulations require debt issuers to acquire a minimum of two ratings, it can deduce that the competition is even more faint. Coffee, J. C. stated in a 2008 testimony at the U.S. Senate: with this lack of competition, "(…) the credit rating agencies needed to worry less about preserving their 'reputational capital'"[49]. Although the importance of competition of credit rating agencies on the financial market is under debate ; it becomes clear that the gatekeeper-function, which is performed by CRAs, is different from other gatekeepers on financial markets such as financial auditors, investment bankers, etc[50].: Whereas gatekeepers such as auditors are liable for the services they provide, credit rating agencies are singularly immune from liability as their rating are either

[46] SEC 2003: 24
[47] Nazareth 2003: [Internet] <http://sec.gov/news/testimony/ts040203aln.htm>, 3 Dec. 2011
[48] The Economist 2007: online [Internet] <http://www.economist.com/node/9267952>, 26 Nov. 2011
[49] Coffee 2008: 1
[50] Deb/Murphy (2009) argue that increasing the number of CRA in order to increase competition may reduce an individual rating agencies reward from maintaining reputation and – with increased competition and decreased market share of each CRA – ratings inflation

explicitly protected by law or represent only "opinions" and therefore are protected by the constitutional "freedom of speech"[51]. This difference in liability is one of problem associated with credit rating agencies. In fact ratings of CRAs are used to define minimum capital requirements or to prohibit certain investments in several regulatory frameworks (even US and Europe). The CRA market is highly saturated and new market participants are confronted with strong market entry barriers: The credit rating market is highly dominated by market entry barriers that reduce competition but increases the market power of few credit rating agencies. The literature proposes several views. The major two state the opposite; more competition could induce CRA's to a permissive and hurried behaviour. The other one claims that the market could only benefit from a wider competition. In general it is necessary to differentiate between artificial market entry barriers coming from regulations and market entry barriers that are innate in the business (but mostly a result of regulation).

❖ Market Entry Barriers by Regulation

Artificial market entry barriers that were created by regulative frameworks are criticized most in the literature because different regulations worldwide , although the liability of credit rating agencies is highly limited as their ratings only represent opinions on the creditworthiness, as said above. It is possible to affirm that two particular changes favoured the construction of an oligopolistic market. The reliance of several regulatory frameworks both in the U.S. and the European Union (Basel II, Basel III, Solvency 2, etc.) on CRAs contributed to the creation of "natural" market entry barriers giving to rating agencies the role of semi-governmental authorities. The formal requirement of using rating agencies that are officially recognized by European regulations create a regulatory incentive to obtain ratings by one of the large CRAs only. Especially after 2008 financial crisis the European Union recognized the overreliance on ratings. It will discuss deeper in the next pages. The second is the use of credit rating agency as "(…) de facto "capital market

[51] cf. Partnoy 2006: 85

gatekeepers"—despite their apparent lack of liability and their reluctance to assume such a responsibility."[52].

❖ Market Entry Barriers inherent with the Business

There exists a number of "natural" entry barriers. The business and the subsequent success of CRA's is based on their own reputation. Precisely reputation is considered as the most important asset of credit rating agencies and has been developed by "the big three" in more than 100 years. The esteem is a deep value that also needs long time to increase and consolidate. Although the involvement of rating agencies in different financial crises and accounting scandals in the years, the reputation of S&P, Moody's and Fitch can still be considered as very strong, which makes it very difficult for new market entrants to enter the market. For this reason, smaller CRA started to offer their services in niches and – more interesting – recently changed their business model from issuer based to a model that is based on subscriptions. Other relevant barriers for the new entrants are mostly related to the size of the current CRAs such as economy-of-scale effects. It is not easy for new entrance participants compete with respect to prices.

1.6.3 Disclosure Practices

The lack of adequate information about the characteristics and limitations of the ratings is one of the main problems (Garcia, 2012). The credit rating agencies disclosure practices raised some concerns in the previous years associated with their failure to adequately disclose information about their exact rating procedures and additional information on the issuer. It is obvious that credit ratings represent valuable information only, if the contexts in which the ratings are valid (e.g. underlying assumptions, rating procedures, etc.) and additional information concerning the issuer (e.g. the existence of rating triggers as described above, as rating triggers could lead to a liquidity crisis of the issuer) are disclosed as well. Increased disclosures of information concerning credit ratings may lead to stronger

[52] The World Bank 2009: 3

reputation and credibility of credit ratings, increased ability of regulatory oversight, a higher quality of credit ratings and overall to more stable and comprehensible credit ratings. Limited disclosure practices lie in the nature of credit rating agencies and can be viewed as an economic problem. CRAs will only provide additional information as long as the marginal benefit for the rating agency exceeds its marginal costs. As credit rating agencies are information providers, their most important asset is know how related to rating methods / procedures and

reputation. For this reason, their marginal costs are associated with the disclosure of information to the public and include among other things the release of confidential information to a CRA’s competitors or to users of credit ratings (who are then able to create internal ratings and no longer require services provided by credit rating agencies), increased vulnerability to potential litigation or decreased reputation when underlying assumptions are proofed wrong retrospectively or credit rating agencies disclose too much information about the issuer.

Disclosure practices are also difficult to assess in regards to confidential information. As mentioned above, following the issuer pays model, the credit rating agencies clients are the issuers itself who rely on the secure processing of confidential information. If credit rating agencies would disclose confidential information from issuers, their reputation would decrease dramatically. On the other side critics argue, if particular information from the issuer is confidential but affects credit ratings, they need to be disclosed85. Otherwise, the third party on financial markets, investors, would base their investment decision on incomplete / imperfect information.

1.6.4 Moral Hazard– Information asymmetry

Information asymmetry between debt issuers and investors is one of the major reasons for CRAs existence. Without information asymmetry there is no sense in the nature of CRA's. They were born to bridge this gap. The asymmetry takes place when sellers have superior information to buyers about product quality and simultaneously cannot convey this information to buyers. Prices in a market with information asymmetry 18 reflect the average quality of a product, and sellers with superior products, bearing the cost of the information asymmetry, wish to disclose the superior nature of their product for charging the highest price (Partnoy, 1999).

Moral hazard problem arises when sellers exaggerate their credibility and provide buyers with false information. CRAs are supposed to serve as a third-party information intermediary between debt issuers and investors, helping the market to determine the appropriate price. By "specializing in the gathering, analysis, examination, and dissemination" of information regarding the creditworthiness of an issuer or instrument, CRAs "eliminate the duplicative and inefficient efforts of individuals engaging in such activities" (Partnoy, 1999). However, hot markets and large profits increase the benefits of inaccurate, hastily determined ratings (Dennis, 2009), thus enabling CRAs abusing their power.

1.6.5 Latency in Rating Downgrades

Credit rating agencies have been criticized after several financial crises and accounting scandals in Europe and the U.S. for their latency in downgrading issuers or securities. As a result of delayed rating downgrades, investors may rely on out-of date ratings that "(…) the agency might not issue today, either because of changed facts or changed methodologies[53]."

The issue associated with the latency in downgrading is in regards to the perception of financial market participants, who perceive the function of credit rating agencies, among other things, as an early-warning function and therefore rely on the information provided by rating agencies. The second problem associated is the reliance of regulatory frameworks on the CRA's judgements.

The reason for the latency has been discussed for years. Credit rating agencies argue, that downgrades are only published if they are long-lasting whereas several researchers argue that credit rating agencies fail in downgrading issuers or securities,

[53] Coffee 2008: 3

because they are not paid to continuously monitor and update their ratings[54]. The problem is once again linked with the business model, as credit rating agencies are only paid (for solicited ratings) at the beginning. The bigger issue is the duopoly of the credit rating agencies' function on the financial markets. On the one side they resolve information asymmetries on the financial markets and as a result contribute to the stability of the market. On the other side, CRAs are used (particularly due to the regulative framework) as gatekeepers. In case of the first function, market participants requests a conservative behaviour of credit rating agencies, i.e. ratings that change only when fundamental credit risk changes and which happens usually quite slowly. "*A minimum number of inevitable rating downgrades and the emphasis on long-term rather than short-term credit risk stabilizes the financial markets"* [55], as the adverse consequences of frequent (and perceived unstable) rating downgrades could be severe: "*Because of the existence of contractual provisions such as "rating triggers*[56]*", ratings downgrades – particularly from investment grade to non-investment grade – can have consequences for the company far beyond that of increasing its cost of capita*l"[57]. In case of the latter, market participants request a continuously valuation of credit risk and immediate changes of credit ratings in response to changing credit risk or market conditions in order to react quickly (e.g. rating triggers as described in the previous chapter). This multiple roles CRAs have to play on financial markets creates inherent conflicting incentives.

1.6.6 Immunity from liability

Prior to the enactment of the Dodd-Frank Act[58], US case law centred on an argument different from privity of contract in order to deny rating agencies'

[54] Coffee 2008: 3
[55] Measures of ratings stability include the frequency of rating changes, the frequency of large "multi-notch" rating changes, and the frequency of rating reversals
[56] "rating trigger" gives to contractual parties the right of immediately repayment of outstanding loans once the credit rating declines under a certain level. SEC 2003: 29
[57] Frost 2007: 9
[58] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (2010)

liability[59]. In order to avoid liability, rating agencies generally argued to be members of the press[60]. CRA immunity principally stems from the designation of their reports as "opinions" which are protected by the First Amendment, within the ambits of Freedom of Speech and Freedom of the Press. CRAs are regarded as operating within the financial publishing industry, with all the resultant constitutional privileges that this entails. Therefore ratings had to be looked at as opinions to be protected under a heightened malice standard[61]. CRAs was immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933. In general, they were not and still are not completely subject to the same fiduciary duties and "gatekeeper" liabilities faced by other financial intermediaries (like investment analysts and auditors)[62]. An often cited explanation points to the fact that CRAs do not have access to the same extent of files and company data that others might have (e.g. auditors), and that they do not conduct any independent scrutiny of the accuracy and exhaustiveness of the provided information[63]. Moreover, opening up the liability floodgates could potentially lead to several abusive claims, as the recipients of credit ratings constitute a much larger pool than the recipients of analysts' and auditors' reports. According to a leading treatise on the subject[64], increased liability could lead to:

- Defensive ratings, whereby the CRA will invest time and resources not in making the product better, but in making it more "liability-proof". This may represent a significant social waste.

[59] For the prevailing case law on the protection of rating agencies under the First Amendment see C. Kettering, Securitization and its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553, 1689-1690 (2008); C. Hill, Regulating the Rating Agencies, 82 Wash. U. L. Qu. 43, 56-57 (2004); T. Nagy, Credit rating agencies and the First Amendment: applying constitutional journalistic protections to subprime mortgage litigation, 94 Minn. L. Rev. 140-167 (2009)

[60] See e.g. T. Pate, Triple-A ratings stench: may the credit rating agencies be held accountable? 14 Barry L. Rev. 25, 45 (2010).

[61] New York Times Co. v. Sullivan, 376 U.S., 254 (1964); in the rating sector see Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 753 (citing Sullivan, 376 U.S. 254)

[62] See Frank Partnoy, How and why credit rating agencies are not like other gatekeepers, University of San Diego School of Law, Law and Economics Research Paper No. 07-46, May 2006, pp. 59-102

[63] See Uwe Blaurock, Control and Responsibility of Credit Rating Agencies, Electronic Journal of Comparative Law, vol. 11.3, December 2007, at p. 22

[64] Husisian, supra note 12, at p. 424

- Cross-subsidization of the increased costs. The CRA will pass on the costs to its subscribers in a uniform manner. This however will work to the detriment of smaller subscribers who will be indirectly subsidizing the larger ones.
- Reducing the number of ratings for smaller and first-time issuers. Those are the most difficult to rate, and the most likely to absorb the costs of increased liability.

Moreover, increased liability would inarguably lead to huge evidentiary burdens for the aggrieved party in establishing negligence, and equally heavy burdens for courts in distinguishing significant factors from insignificant ones. Despite this general protection, recently after the financial crisis there were unsuccessful attempts to raise this defence, when the agency was found to have been an active participant in structuring the proposed transaction[65] or to have been subject to conflicts of interest resulting from this role or from the fee structure underlying this issue and amounting to a contingent fee and the resulting improper motivation[66]. In the latter case the rating was only paid if the rating was actually used in the offering. In light of these obstacles to plaintiffs bringing suits against credit rating agencies, in the aftermath of the financial crisis the US legislator introduced a private cause of action in the Dodd-Frank Act under which investors can sue credit rating agencies for knowingly or recklessly failing to conduct a reasonable investigation of facts or for failing to obtain an analysis from an independent source[67]. More importantly, Dodd-Frank included a repeal of Rule 436(g) of the Securities Act of 1933, thus subjecting rating agencies to 'expert liability' for misleading statements in registration statements under Section 11 of the 1933 Securities Act. Under such an expert liability according to Section 11 an expert is held liable except in cases where he shows that he met the due diligence requirement, i.e. that he had, 'after reasonable

[65] Cal. Pub. Employees' Retirement Sys. v. Moody's Corp., No. CGC-09-490241 (Cal. App. Dept' Super. Ct. July 9, 2009) § 47, 38, http://online.wsj.com/public/resources/documents/calpers.pdf (accessed 30 May 2013); for a detailed analysis cf. N. Ellis, L. Fairchild and F. D'Souza, Conflicts of interest in the Credit Rating Industry after Dodd-Frank: Continued Business as Usual?, 17 Stan. J.L. Bus. & Fin. 175, 203-210 (2012); D. Grais and K. Katsiris, Not „The World's Shortest Editorial“: Why the First Amendment Does not Shield the Rating Agencies from Liability for Over-Rating CDOs, Bloomberg L. Rep., (12 Nov. 2007), 40, 41.
[66] Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 166-167, 179-180 (S.D.N.Y. 2009).
[67] Dodd-Frank § 933.

investigation, reasonable ground to believe and did believe' that there were no misstatements or omissions of material facts in the portions of the registration statement he prepared[68].

The implementation of this newly created liability turned out to be difficult and the repeal does not have the previously hoped for effect as regulatory behaviour control. The major rating agencies refused to have their ratings included in registration statements, so that issuers were unable to include them in their registration statements as prescribed by Regulation AB[69]. A virtual standstill in the market for asset-backed securities resulted[70].

As a consequence, the SEC found itself forced to release a no-action letter to avoid enforcement actions so long as the amendment could not be effectively implemented on July 22, 2010, which was to be applied until January 24, 2011.

But even after that date, there has not been any evidence of activities of the SEC to bring enforcement practices in line with the newly introduced expert liability of rating agencies as provided for after the repeal of Rule 436(g) of the Securities Act, despite some officials', such as Massachusetts Attorney General Martha Coakley's pushing towards enforcement[71]. As a consequence of the no-action letter, on the one hand, it is true that the probability of SEC action has decreased, without however altering the technical requirements of Regulation AB. Therefore issuers who do not include ratings in their registration statement in reliance on the SEC's no-action letter may be subject to investor claims of noncompliance with Regulation AB. As a result, the repeal of Rule 436(g) has created a dilemma in the sense that it results in either party's liability, depending on whether the ratings are included or not, without actually clarifying the crucial issues of the liability problem. In the long run, it may even go so far as to make issuers rely on private placements, to which Rule 144A of

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68 Dodd-Frank/Securities Act 15 U.S.C. § 77k (b)(3)(B)(i)

69 SEC Regulation AB §§ 1103 and 1120, 17 C.F.R. § 229.1100.

70 B. Brownlow, Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities, 15 N.C. Banking Inst. 111 (2011).

71 Letter from Martha Coakley, Attorney General of Massachusetts, to Mary Shapiro, Chairman of Securities and Exchange Commission (March 1st, 2011), http://www.mass.gov/ago/docs/press/2011/2011- 03-07-sec-letter-attachment1.pdf (accessed 30 May 2013).

the Securities Act[72] and a safe harbour from registration requirements applies. As a result, these investment opportunities would not be open any more for retail investors. [73] In EU, with the agencies' ratings moving to the centre of the debate in the current sovereign debt crisis and the repercussions of wrong downgrades becoming greater[74], the liability issue was subject to an unprecedentedly intense regulatory debate in the rating industry. The European Commission through a proposal for a regulation (CRAIII), which was adopted by the European Parliament in 2013, entered into force in June of the same year, to amend and strengthen the 2009 version of the EU Rating Regulation, processed this argument imposing civil liability on the agencies. This specific section will be subject of dissertation in a deeper way in the third chapter.

2. INTERNATIONAL BODIES

2.1 The International Organization of Securities Commissions (IOSCO)

Globally, the International Organization of Securities Commissions (IOSCO) includes over 100 securities commissions (IOSCO, 2012). In September 2003, IOSCO Principles were published for securities regulators, CRAs, and market participants to improve investor protection, fairness, efficiency and transparency; and to reduce systemic risk. When developing the principles, IOSCO acknowledged that CRAs were regulated differently in each jurisdiction, and allowed CRAs to decide on the best way to give effect to the principle. In December 2004 IOSCO developed "Code of Conduct Fundamentals for Credit Rating Agencies". In May 2008, the 2004 code of conduct was updated in order to address the problems that emerged in the credit markets (IOSCO, 2008a). In March 2009, the IOSCO reviewed its code implementation throughout the world (IOSCO, 2009). The Code Fundamentals were developed out of discussions among IOSCO

[72] 17 Code of Federal Regulations (C.F.R.) § 230.144A (2013)

[73] N. Blumberg/J. Wirth/N. Litsoukov, The Liability of Credit Rating Agencies to Investors: A Review of the Current Liability Regime and Recent SEC Proposals, 16 J. of Structured Fin. 34, 44 (2011).

[74] For the example of the wrong downgrade of France cf. BBC News, S & P accidentally announces downgrade of French debt, BBC News of Nov. 10, 2011, http://www.bbc.co.uk/news/business-15686580 (accessed 30 May 2013).

members, CRAs, representatives of the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors, issuers and the public (IOSCO, 2008b).

The principles that were revised in 2010 can basically be seen as a voluntary framework that is implemented in national regulations or standards. The IOSCO noted that "(…) *the mechanisms for implementing the principles may take the form of any combination of Government regulation; Regulation imposed by nongovernment statutory regulators; Industry codes; and Internal rating agency policies and procedures.*[75]"

It is necessary to describe a framework of principles on which basis credit rating mechanisms are evaluated. The attributes are divided in principles already suggested by official authorities - most of all the IOSCO – and principles/attributes that are newly derived by issues related to CRAs that were evident in the recent financial crises.

2.1.1 IOSCO CRA Principles

Regulation of credit rating agencies poses a challenge, as these entities are on the one side based in different with different jurisdictions and on the other side rate different companies in different countries that operate under different regulatory regimes. In order to facilitate the regulatory oversight the IOSCO founded a task-force to study issues related to credit rating agencies and issued four principles that were published in 2004. Since then, the IOSCO monitors the implementation of these principles in cooperation with the national country member's authorities.

The revised code of conduct includes the following principles, which are:

a) Quality and integrity in the rating process;
b) Independence and conflicts of interest;
c) Transparency and timeliness of ratings disclosure; and

[75] IOSCO 2010: 8

d) Confidential information.

a) QUALITY AND INTEGRITY IN THE RATING PROCESS.

"Quality and integrity in the rating process – CRAs should endeavor to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants."[76]

The first principle issued by the IOSCO is associated with the quality of issued credit ratings by the CRAs. Thus, credit rating agencies should issue ratings that are based on informed analysis in order to improve transparency on financial markets. Whereas the IOSCO explicitly states that credit ratings should assist market participants in determining the degree of relatively credit risk of debt issuers or debt instruments, it does not suggest the necessary methods and procedures. This is also true on a regulatory level, both US and Europe prohibit any regulation of the substance of credit ratings and its methodologies and procedures by the supervision authorities. For this reason, the IOSCO's objective focuses on *"(...) controls and processes designed to ensure that whatever methodology a CRA employs to determine credit ratings (e.g., a qualitative assessment of relevant factors, a quantitative model using relevant inputs, or a combination of both) is employed in a systematic and consistent manner by competent analysts and that the results can be reviewed to assess whether the methodology produces ratings that do enhance the ability of market participants to assess relative creditworthiness.*[77]" The first IOSCO principle can be split into two sections. The first part regards procedures and methodologies used in the credit rating process. Here, the IOSCO requests the implementation of systematic rating procedures and the consistently use of credit rating methods. Although it is obvious that based on the nature of credit rating agencies (private companies, etc.), the regulatory power of institutions such as the IOSCO is limited to guideline/codes of conduct. In the principle statement cited above, the IOSCO acknowledges that credit ratings represent "opinions" which is

[76] IOSCO 2010: 20
[77] IOSCO 2010: 20

problematic as legal constraints in case of misconduct by the credit rating agencies would be difficult to enforce. Furthermore, "opinions" define the scope of credit ratings too widely, which is also problematic as failures in credit rating are difficult to track and to proof. The second part of this principle, request by the IOSCO, regards to quality and integrity: the IOSCO requests the monitoring and continuously update of ratings, the maintenance of internal records, that reflect all information known at the time of the rating, and sufficient resources (well skilled/trained analysts, etc.). Continuously updated credit ratings are necessary especially in case of rating downgrades as based on the regulatory framework; different market participants rely on updated credit ratings. The IOSCO did not defined the timely basis on which rating updates should be implemented and published. Instead – in response to several criticisms - the IOSCO revised its code of conduct and improved this part of its principle by declaring in 2004: "updating (credit ratings) on a timely basis, as appropriate, based on the results of a review." [78] Certainly, principles in regards to quality and integrity of the rating procedures and methods are very important for the existing system . Unfortunately, this principle is very difficult to define and much more difficult to monitor and to supervise.

b) INDIPENDENCE AND CONFLICS OF INTEREST.

"Independence and conflicts of interest – CRA rating 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 employees. CRAs should, as far as possible avoid activities, procedures or relationships that may compromise or appear to comprise the independence and objectivity of credit rating operations."[79]

The objective of the second principle published by the IOSCO is the issuance of credit ratings that are not influenced by factors that are irrelevant to the rating of the credit worthiness of an issuer or a debt instrument. It addresses internal procedures

[78] IOSCO 2004: 5
[79] IOSCO 2010: 26

and mechanisms to identify potential conflicts of interest during the rating process and eliminate them. The principle focuses in particular on the business relationship between the credit rating agency and the client (issuer) and requests that any potential source of conflicts of interest may be avoided in advance. Similar to compliance procedures implemented in many companies worldwide, the second IOSCO principle suggests the implementation of internal control mechanisms to adhere the independency and objectivity of credit rating agencies.

This principle is problematic on two fronts. First, the implementation of internal control mechanisms, as it is requested by the IOSCO, needs to be enforced much stricter than it is the case with regular compliance procedures. In order to enforce the implementation, it would be necessary to supervise them as well, which is difficult as credit rating agencies are not completely subordinated to supervision authorities but represent private entities. Second, it is not to neglect, that credit ratings are the major income source of credit rating agencies and therefore are exposed to several types of possible conflicts of interest – internal (e.g. staff compensation) as well as external. It is understandable, that CRAs behave on an economic and rational basis, which makes it difficult to differentiate between any conflicts of interest in the sense of the IOSCOs principle and normal business behavior.

c) TRASPARENCY AND TIMELINESS OF RATING DISCLOSURE.

"*Transparency and timeliness of ratings disclosure – CRAs should make disclosure and transparency an objective of their ratings activities.*[80]"

The third principle issued by the IOSCO should provide sufficient information regarding particular credit ratings so that all users of credit ratings (investors, regulatory entities, sovereigns, etc.) are able to understand the procedures and methodologies by which credit rating agencies obtain ratings. Furthermore, the principle includes the disclosure of the rating context the meaning of the credit rating. In the past years, the principle was supplemented by guidelines regarding the timing of information disclosure. The call of the IOSCO for transparent rating

[80] IOSCO 2010: 31

procedures in late 2003 is - retrospectively – comprehensible. In the last years, several substantial changes were executed in regards to disclosure practices, many of them on a voluntarily basis by the credit rating agencies (e.g. disclosure of rating methodologies, etc.). Although the transparency of credit ratings was increased by rating agencies, another issue associated with the disclosure of ratings was raised and is discussed heavily, most notably in regards to sovereign ratings, since the European Sovereign Debt Crisis: The timing of the publication of credit ratings. Several European officials blamed credit rating agencies for contributing to volatility in the sovereign debt market and driving up borrowing costs for troubled governments in the Eurozone.. This brings on evidence the relationship between the announcements of sovereign credit ratings and market spreads.. Another study, carried out in 2004 by the Bank of International Settlement, shows evidence that especially negative rating events (disclosure of credit rating) have a highly significant impact on credit spreads on the credit default swap (CDS) market. The announcement of rating downgrades are not responsible alone for negative movements. Solely the announcement of reviews or even economic outlooks by rating agencies could have impact on the perception of credit risk. This factor leads to a problem associated with the regulation of announcements: As credit rating agencies are privately owned entities and announcements represent opinions, a regulation of publishing opinions would violate the constitutional freedom of speech in the U.S., the European Union and most other relevant countries in the world. This issue ends in the same old dichotomy.

d) CONFIDENTIAL INFORMATION.

"Confidential information – CRAs should maintain in confidence all nonpublic information communicated to them by any issuer, or its agents, under terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially."[81]

The final principle issued by the IOSCO is not described extensively in the code of conduct and requests procedures and mechanisms to protect confidential information

[81] IOSCO 2010: 35

(non-public information) disclosed to the credit rating agency by the issuer. In the second part of the principle the IOSCO requests "(...) the restriction of the use of such non-public information to purposes related to rating activities or otherwise as agreed upon by the issuer."[82] The handling of confidential confirmation and possible misuse is the only principle that is also regulated by national and international jurisdiction and that is strictly enforced by credit rating agencies themselves, as a breach of this principle would damage CRAs reputation. The next chapter provides an overview of additional attributes that are necessary for the discussion of alternative rating approaches.

According to the IOSCO , the principles will help to reinforce confidence of investors and the market in the process of rating assignment.

2.2 Basel Committee on Banking Supervision (BCBS)

The Basel II Framework comprises a set of standards for establishing minimum capital requirements. It was prepared by the BCBS that developed the first standard in 1988 (Basel I) . As announced in June 2004, BCBS under the supervision of the Bank for International Settlements (BIS), assigned credit ratings a central role. BCBS permits banks to use ratings from certain accredited CRAs to determine minimum credit risk capital requirements under Pillar I of the Basel Capital Accord (Basel II).

The Basel II framework provides tables that attribute different risk weights to each rating grade issued by a recognized External Credit Assessment Institution (ECAI). As stated by the EBA's guidelines on ECAIs, the ECAI recognition for capital purposes does not constitute a form of regulation of ECAIs or a form of licensing of rating agencies to do business in the EU. As part of the global initiatives endorsed by the FSB and the G-20 leaders, BCBS has advocated a single set of global financial standards as part of a more comprehensive response to the financial crisis of 2008. The text of this reform called the Basel III Framework, was issued by the

[82] ibid

BCBS in December 2010. Basel III complements the Basel II and Basel I frameworks but does not replace them.

- **Basel II provisions**

One of the main tasks of the accord first pillar is to measure in a standardized and reliable manner the credit risk faced by bank institutions. This kind of risk must be assessed following the methods prescribed in the provisions and the results need to calculate the capital requirement. In Basel I was attributed to an adequate capital structure, regarded as a necessary feature to ensure the banks' stability towards the risks, and this aim was consolidated in Basel II. Dating back to 1988, Basel I accord had already tried to regulate in an appropriate manner the banks' capital requirements linking them to their own risk exposures. The issue that came out was Basel I promoted a risk assessment that was mainly based on exogenous and very standardized components, providing a very strict and inaccurate measurement of the real exposure without being sensitive enough about the banks' actual situations. the parameters were too strict. Using the IRB approach the capital requirements are closer to its own credit risk profiles. For these reasons Basel II provisions pay more attention to the accuracy and the nature of the ratios whom the capital requirement are based onto. The purpose of the new accord was to attribute an accurate and actual value at the risk exposure towards each bank's counterpart. Moreover they wanted to develop a soft set of rules that could allow the banks themselves to pick, among multiple different approaches, the one more comfortable .

Hence, Basel II accord developed two main different approaches that could be adopted to measure credit risk: the Standardised Approach (S.A.), using ratings issued by external entities, and the Internal Rating Based Approach (I.R.B.), based on ratings developed by the bank itself.

In both of the mentioned approach the credit rating agencies play a fundamental role, since they are designed to realise a rating on risk exposure position. The Standardised Approach is designed to produce a more accurate risk assessment than the one adopted in Basel I, maintaining at the same time the procedure rather simple and avoiding twisted and complicated steps in the capital requirement calculation. In following this approach banks need to use the ratings issued by an External Credit Assessment Institution (ECAI) after having assessed their global risk exposure, so that credit rating agencies are required by regulation to provide a crucial service. Then according to the bank national supervisor guidelines, the bank has to associate a peculiar risk weight available with each issued rating according to Basel II framework [83].

The provided weighted exposures allow the bank to quantify the value of the Risk Weighted Assets (RWA) that is the ratio that, according the provisions, must be used to calculate the 8% capital requirement. The provided weighted exposures allow the bank to quantify the value of the Risk Weighted Assets (RWA) that must be used to calculate the 8% capital requirement. So, Basel II raises the same issues to create firstly a new profitable market for a specific entity, and then to restrict the access to such market, as mentioned in the previous chapter. Beyond the Standardised Approach, the ECAI keep playing an important (even if not essential) role also in the Internal Rating Based Approach. Under this second approach it's the bank institution itself that assesses its credit exposures and issues a rating that subsequently will be associated with a peculiar weight. The bank has to evaluate a model following the parameters and the calculation steps prescribed by the accord provisions .[84] The Internal Rating Based approach include two different exposures evaluation techniques: the Foundation Internal Rating Based Approach (F-IRB) and the Advanced Internal Rating Approach (A-IRB). Under both of these methods the bank has to develop its own models to calculate the risk exposure, but while in the more free-form Advanced IRB approach the model developed concerns even the basic parameters used to calculate the Risk Weighted Assets- such as the Probability

[83] BASEL COMMITTEE ON BANKING SUPERVISION (2006), Part 2, II, C, 1. "Supervisors will be responsible for assigning eligible ECAIs' assessments to the risk weights available under the standardised risk weighting framework, i.e. deciding which assessment categories correspond to which risk weights. The mapping process should be objective and should result in a risk weight assignment consistent with that of the level of credit risk reflected in the tables above. It should cover the full spectrum of risk weights.

[84] BASEL... (2006), Part 2, III, a according to which "Subject to certain minimum conditions and disclosure requirements, banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure".

of Default (PD), the Exposure at Default (EAD), the Loss Given Default (LGD) – in the simpler Foundation IRB these parameters are given by the regulator. The regulator purpose in developing this new alternative model of credit risk assessment was to make capital requirement closer to the bank's actual credit risk profile. According to this approach no one can evaluate better its own risk exposure more than the bank itself, due to the quality and the amount of information that it owns. The bank is only subject to an external control by the national authority, whose task is to supervise whether the developed assessment system is sound, correct and compatible with the rules. So among the three approaches stated in Basel II, two of them practically establish a very tight relationship between banks and credit rating agencies. In fact Basel II rules seem to give rise to more or less the same controversial issues about competition in the rating market, regulatory rent seeking opportunities and possible conflict of interest situations. It deserves to be examined concerns the ECAI's market structure and the way they (ECAI agencies) are appointed. Paragraph 90 of Basel II accord states that it's a national supervisors' task to verify through public assessments whether an ECAI meets the criteria listed in the following provisions, that constitute the pillars of ECAI's regulation itself.

These criteria are:

- Objectivity, the methodologies in assessing exposures must be rigorous, systematic, sensitive to historical experience, subject to ongoing review and tested for preferably three years before being adopted;
- Independence, and potential conflict of interest[85];
- International access / Transparency, no discrimination between a foreign and domestic institution and available information about the methodology used;
- Disclosure, according to which an ECAI should disclose its assessment methodologies, information concerning its definition of default, its time

[85] BASEL… (2006), §91 precisely states : "An ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any
constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating a conflict of interest.

horizon, the meaning of their ratings, and statistical data such as the experienced default rates and the transition from a rating class to another;

- ❖ Resources, according to which an ECAI has to be provided with the necessary resources to carry out high quality assessments, combining quantitative and qualitative parameters.

The whole ECAIs' recognition process is openly ascribed to single national regulation, having to obtain different solutions from different national authorities and then to stimulate a race to the-bottom regulatory competition that lead to a distorted access to ECAI's market. Of course, these are not mandatory rules but guidelines and the final implementation of Basel II accord is up to each single national supervisor authority. Even in this case return all the issues related to the conflict of interest it the case of unsolicited ratings, but this is not neglected by Basel II provisions as explained at accord paragraph 108. This paragraph affirms national supervisors are able to allow banks also to use unsolicited rating in calculating risk weighting, but at the same time supervisors are warned about the risk of agencies using that kind of rating to exert an abusive pressure on banks. It is then prescribed that, once an abuse of that kind is proved to have occurred, the supervisor should reconsider the eligibility of the agency as an ECAI. According to CESB guidelines an agency who applies has to specify which kind of rating it intends to issue, solicited or unsolicited. The CESB guideline and the specific legislation will be discussed in the following chapter. Finally, has to be appreciated that Basel II regulator appears to be perfectly aware of the unsolicited ratings problem, and its aim is to induce national supervisors to watch over the issuing and the use of unsolicited ratings. Another issue that is usually associated with the use of ratings for regulatory purposes is about the so-called "cherry-picking" practice. A bank may decide to choose several ECAIs to conduct a single assessment and, among the ratings issued, to choose the higher one for obvious reasons. In Basel II under paragraph 94 it is prescribed that this is not allowed to "cherry-pick" the assessment provided by different ECAIs,. To enforce this provision, the accord set some specific and pragmatic rules. In fact, it is prescribed that when two assessments are available, the bank has to choose the one that corresponds to the higher risk weight.

Moreover when more than two assessment with different risk weight are available, the bank has to choose the ones associated with the two lowest risk weights and then, pick the highest risk weight between them. These rules appear to be well designed, since they are very easy to apply. Both set of rules tend to create a new profitable market sector for credit rating agencies, but they seem to put an entrance barriers since such market requiring the applicants to comply with costly criteria. Therefore regulation seems to privilege the biggest known players instead of fostering competition. To conclude, it is possible notice that although it's important that the criteria to comply with in order to be appointed as ECAI require the agency to act in an objective and independent way, it seems as well difficult to achieve a full control over this kind of market actors given to their peculiar business activity, as said several times.

2.3 G-20 The Group of Twenty.

The Group of Twenty Finance Ministers and Central Bank Governors (G20) is the premier forum for international cooperation on the global economy and financial agenda.

The objectives of the G20 refer to:

1. Achieve global economic stability, sustainable growth;

2. Promote financial regulations to reduce risks and prevent future financial crises;

3. Modernizing international financial architecture (G-20, 2013a).

2.4 Financial Stability Board (FSB)

The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G7 Finance Ministers and Central Bank Governors. In November 2008, the Leaders of the G20 countries called for a larger membership of the FSF (FSB, 2013a). The FSB has been established to coordinate the work of national financial authorities internationally (FSB, 2013b).

- Principles for reducing reliance on CRA ratings.

The FSB published in 2010 a report whose aim was "to catalyse a significant change in existing practices, to end mechanistic reliance by market participants and establish stronger internal credit risk assessment practices instead”.[86] The report divides the objectives into three main points. In the first the FSB addresses directly to the authorities, inviting them to remove or replace References to CRA ratings, only once alternative provisions in laws and regulations have been identified and can safely be implemented.

3. EU REGULATION

3.1 The European supervisory framework

The European supervisory framework incorporates:

- The European Systemic Risk Board (ESRB), which monitors and assess potential threats to financial stability.
- The European Securities Markets Authority (ESMA), based in Paris.
- The European Banking Authority (EBA) based in London.
- The European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt (ESMA, 2013b).

Before and during the financial crisis in 2007 and 2008, the European Parliament has called for a move towards more integrated European supervision in order to ensure a true level playing field for all actors at the level of the European Union and to reflect the increasing integration of financial markets in the Union. As a

[86] Financial Stability Board, ‘Principles for Reducing Reliance on CRA Ratings’, 27 October 2010, 1

result, the supervisory framework was strengthened to reduce risk and severity of future financial crises.[87]

3.1.1 The European Commission (EC)

European Commission is the executive body of the European Union responsible for proposing legislation, implementing decisions, upholding the EU treaties and managing the day-to-day business of the EU. Its job is to represent and uphold the interests of the EU as a whole. Like the Parliament and Council, the European Commission was set up in the 1950s under the EU's founding treaties. As the European Commission (EC) is the driving force in proposing legislation (to Parliament and the Council), it holds an essential role when it comes to CRAs regulations.

3.1.2 European Securities and Markets Authority (ESMA)

ESMA is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. On 7 December 2009, the EU Regulation 1060/09 on CRAs entered into effect. Following the announcement of the creation of ESMA , the CRA Regulation was revised in December 2010 [to give] ESMA an exclusive responsibility for the registration and supervision of CRAs in the EU, in cooperation with EBA, EIOPA and IOSCO. ESMA contributes to the work of the European Systemic Risk Board (ESRB), by providing data and undertaking stress tests in close co-ordination with the fellow ESA's and the ESRB (ESMA, 2013a).

3.1.3 The European Banking Authority (EBA)

The EBA was established on 1 January 2011 as part of the European System of Financial Supervision (ESFS) and took over all existing responsibilities and tasks of

[87] EIOPA 2013. [Internet]. https://eiopa.europa.eu/about-eiopa.

the Committee of European Banking Supervisors. The European Banking Authority (EBA) is an independent EU Authority which safeguards public values: the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking whose objective is to provide a single set of harmonised prudential rules for financial institutions throughout the EU. The Authority also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector. (EBA, 2013).

3.1.4 The European Insurance and Occupational Pensions Authority (EIOPA)

The European Insurance and Occupational Pensions Authority (EIOPA) was established in consequence of the reforms to the structure of supervision of the financial sector in the European Union. Article 9 of Regulation 1094/2010, establishing EIOPA. The reform was initiated by the European Commission, following the recommendations of a Committee of Wise Men, chaired by Mr. de Larosière, and supported by the European Council and Parliament. It requires EIOPA to take a "leading role" in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market (EIOPA, 2013).

3.2 Regulation

3.2.1 The First Initiative to Regulate CRAs in the EU

After Enron debacle in 2001, the Economic and Financial Affairs Council (ECOFIN) in April 2002 requested the European Commission to assess the activities of credit rating agencies. At the Oviedo Informal Economic and Financial Affairs Council in April 2002, the European Commission (EC) called for a cross-sectorial policy assessment to determine whether regulatory intervention in the area of CRAs was necessary within the EU. It was the Parmalat scandal back in 2004 and a political perception amongst some that CRAs had been deficient in discovering and responding to that episode that originally led to the European Parliament mandating the European Commission to explore whether CRAs needed regulating. The Commission called for advice from the Committee for European Banking Supervisors ('CEBS') in late 2004. Therefore, in the EU, the first initiative to regulate CRAs was European Parliament's Resolution adopted in February 2004, which asserted the positive role of CRAs but also emphasized problems that warranted further action to ensure the CRAs performed responsibly. In order to prepare its report to the European Parliament, the European Commission (EC) requested ESMA (CESR) to provide Technical Advice on Possible Measures concerning Credit Rating Agencies to the EC published in March 2005. Annex to the Call to CESR for Technical Advice on Possible Measures Concerning Credit Rating Agencies summarises main features of the European Parliament resolution (EC, 2004a):

- ❖ Calls upon the Commission to undertake all necessary steps, including in particular a cost-benefit analysis of the effects on European capital markets, to assess the establishment of a competent European Registration Scheme under the auspices of the Committee of European Securities Regulators (CESR) for the registration of rating agencies in Europe…

The Resolution included the regulatory discussions on CRAs over the past years and overviewed possible registration regime for CRAs in the EU and to ensure that any provisions adopted are consistent with the review of capital requirements for banks and investment firms (Basel II) (EC,2004a) requesting the EC to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals (EC, 2004a). In conclusion the CESR's technical advice to the EC, published in March 2005, ESMA (CESR) proposed not regulating CRAs at the European level but for the time being adopting a system of self-regulation, with a monitoring of the degree to which CRAs applied the voluntary rules set out in the IOSCO Code (CESR, 2005)(*wait and see* *approach*). In its communication, the European Commission [88]endorsed the view of CESR considering not necessary any new regulatory initiative regarding CRAs. The former Committee of European Securities Regulators (CESR) thereafter conducted a study for the European Commission that recommended that new legislation was not necessary to address the failings of credit rating agencies. Besides this recommendation the Commission relied on the international IOSCO Code of Conduct of 2006, that provided general guidelines and which favoured self-regulation to ensure the accountability of rating agencies. The CESR was also confident that the existing financial services Directives applicable to CRAs – combined with self-regulation on the basis of the International Organization of Securities Commission ('IOSCO') Code – would provide an answer to all the major issues of concern'. The Market Abuse Directive ('MAD'), which the Commission made clear applied to CRAs, and that if a CRA knew or ought to have known that its rating was false or misleading, the prohibition on market manipulation may apply and The Capital Requirements Directive ('CRD'), which sets the standards by which a CRA will be recognised as providing adequate ratings for use by banks when calculating their capital adequacy requirements; and includes a number of transparency and governance rules and procedures.[89] Nevertheless CESR's initial investigation found that most CRA codes complied with the IOSCO Code of Conduct with two major exceptions: ancillary services and unsolicited ratings. The CESR's second report on CRA compliance with the revised IOSCO Code of Conduct, published in May 2008, found that some of the improvements suggested in the 2006 report had been implemented, but CESR's expectations for improvement were only partially met[90]. This second report also contained an analysis of the role of CRAs in structured finance. CESR found that while changes needed to be implemented in the areas of transparency, human resources, monitoring of ratings, and conflicts of interest, there was "no evidence that regulation of the credit rating

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[88]EUROPEAN COMMISSION. Communication from the Commission on Credit Rating Agencies (2006/C 59/02).

[89] Directive 2003/125/EC (Market Abuse Directive 2006/48/EC (Capital Requirements Directive) and Directive 2004/39/EC (Markets in Financial Instruments Directive).

[90] CESR, CESR's Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance, 225, CESR Doc. CESR/08-277 (May 2008),

industry would have had an effect on the issues which emerged with ratings" of U.S. Hence CESR continued to support market-driven improvements. However, CESR did recommend that the EC form a CRA standard-setting and monitoring body to develop international standards for the credit rating industry.

3.2.2 Regulation (EC) No 1060/2009

As a result, before the outbreak of the financial crisis, the regulatory setup in Europe was based mainly on self-regulation within certain supervisory "crash barriers" in the form of the IOSCO Code. The turning point for EU to take CRA regulations under serious considerations was the international consensus on a need to regulate CRAs', reached by the G-20 leaders at the April 2009 summit (Garcia, 2012). The European Commission rejected CESR and ESME's[91] advice for continued self-regulation, believing stronger oversight was necessary in light of the economic crisis, and that CRAs should be subject to registration in the EU.

"*Self-regulation based on voluntary compliance with the IOSCO code does not appear to offer an adequate, reliable solution to the structural deficiencies of the business. While the industry has come up with several schemes for self-regulation, most of these have not been robust and or stringent enough to cope with the severe problems and restore the confidence in the markets. Moreover, individual approaches by some of the credit rating agencies would not have the market-wide effect necessary to establish a level playing field across the EU and preferably worldwide.*"[92]

Therefore, end of 2008 the Commission adopted a proposal to regulate CRAs[93]. In its resolution of April 2009 the European Parliament approved the proposal [94] and on

[91] EUROPEAN SEC. MKT. EXPERT GROUP [ESME], *ROLE OF CREDIT RATING AGENCIES 8* (June 2008).
[92] Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, at 4, COM (2008) 704 final (Nov. 12, 2008).
[93] Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, supra note 14.
[94] Resolution of 23 April 2009 on the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies, Eur. Parl. Doc. P6_TA(2009)0279 (2010)

7 December 2009 Regulation No 1060/2009 on CRAs entered into application[95]. This initial regulation introduced the principle of mandatory registration for CRAs operating in Europe, but it was not then clear who would supervise the CRAs[96]. In order to develop its own CRA regulation, the European Commission sought input on proposed regulatory options relating to CRA authorization and supervisory processes, in addition to a proposed directive. Almost in parallel to the process of seeking legislative approval for Regulation No 1060/2009 the Commission made plans for a much broader approach to financial market supervision in the EU, thereby reforming the Lamfalussy framework and its committee structure[97]. Against the background of the findings of the De Larosiere group [98] in September 2009 the European Commission adopted legislative proposals aimed at strengthening macro-prudential supervision through the establishment of a European Systemic Risk Board (ESRB) and micro-prudential supervision through the setting up of a European System of Financial Supervisors (ESFS) comprising of three European supervisory authorities, namely the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and ESMA. ESMA was established 2010 in the Regulation No 1095/2010 with exclusive supervisory powers over CRAs. Therefore, the Commission presented in June 2010 a proposal for a regulation amending Regulation No 1060/2009 to adapt the regulation to the creation of ESMA[99].

Following a period of consultation, Regulation No 513/2011 entered into force on 1 June 2011 entrusting ESMA with exclusive supervisory powers over CRAs registered in the EU in order to centralize and simplify their registration and

[95] Council Regulation 1060/2009, of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, 2009 O.J. (L 302) (EC).
[96] Coffee, supra note 7, at 249.
[97] See generally Jakob de Haan & Fabian Amtenbrink, Credit Rating Agencies, DNB WORKING PAPER 19 (2011).
[98] The de Larosière Group (Feb. 25, 2009), http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf. 21 Council Regulation 1095/2010, of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331)(EU).
[99] Proposal for a Regulation of the European Parliament and of The Council Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, COM (2010) 289 final (June 2, 2010).

supervision at European level[100]. ESMA represents today the first pan-European body with day-to-day regulatory authority over the securities markets[101]. In November 2011 the Commission announced proposals to toughen that framework further and deal with outstanding weaknesses[102].

3.3 CRA Supervisory Structure.

3.3.1 Colleges of Supervisors.

During the debate that took place in the negotiation process of the CRA's regulation, The Commission services have analysed different policy options. There were three options for supervision (from lesser to greater degree of harmonization) by: supervision by Home Member State, supervision by Several countries (through colleges of supervisors) coordinated by ESMA and the possibility of the European agency. A compromise was a mixed system: supervision and registration decisions had to be discussed by several institutions (college of supervisors and ESMA) prior to their adoption by the competent authority of the home Member State.[103] The EU Regulation, which set up a system of colleges of supervisors, was approved in November 2009. The main harmonizing force was the European Parliament, which at that time was unable to launch a European agency for the CRAs supervision. However , as Recital 51 mentioned this supervisory architecture provided in the regulation should not be considered the long-term solution and considered that reform of broad scope would be necessary in the supervisory model, according to

[100] Council Regulation 513/2011, of the European Parliament and of the Council of 11 May 2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, 2011 O.J. (L 145) (EU).
[101] Coffee, supra note 7, at 249.
[102] Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, COM (2011) 747 final (Nov. 15, 2011); Proposal for a Directive of the European Parliament and of the Council 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 (Nov. 15, 2011).
[103] Raquel García Alcubilla, Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation,2012.

the Report of the High-Level Group on Financial Supervision in the EU by De Larosière Group (De Larosière Group, 2009).

3.3.2 The Operation of Colleges

Colleges set up by European supervisors were in charge of the registration and supervision of EU CRAs from June 2010 until July 2011. The colleges handled the applications for registration from European CRAs when the CRA Regulation became effective. Among those applicants were the EU subsidiaries of the major international CRAs. The European CRAs had to register with ESMA (formerly CESR) by 7 September 2010 (CESR, 2010).[104] A total of 45 legal entities registered in the EU within the set date. EU competent authorities formed six colleges of supervisors and were obliged to coordinate with each other (CESR, 2010). The decision to register an agency required unanimity of members of the college. In the event of disagreement the Regulation provided an appeal process to ESMA (CESR). Otherwise, ESMA (CESR) resolved all the other issues. In June 2010 ESMA (CESR) published a more extended guidance on registration (CESR, 2010).

In its report published in December 2010, ESMA (CESR) included a first assessment of the functioning of the colleges of competent authorities, concluding that *"The operation of these frameworks has revealed some difficulties mainly linked to the problem of ensuring consistency*" (CESR, 2010).

The CRA Regulation posed troubles for national authorities that had to set up registration and supervision of CRAs in a very short time frame, especially given that already in July 2011 ESMA took over all supervisory activities over CRAs (CESR, 2010).[105]

3.3.3 ESMA Regulation Competencies: The Role of ESMA.

[104] CESR (December 2010) *Annual Report according to article 21 of Regulation (EC) 1060/2009 on Credit Rating Agencies (Ref CESR/10-1424)*

[105] Raquel García Alcubilla, Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation,2012.

On 1 January 2011 the new European System of Financial Supervisors (ESFS) was established to unify the members of financial supervision at a national and the EU level[106]. The ESFS is composed of the supervisory authorities of the Member States and four new bodies: ESMA, EBA, EIOPA, and ESRB (ESMA, 2013b).

3.3.3.1 Registration and Supervision of CRAs

The amendment to the CRA Regulation adopted in 1st July 2011 [107](CRA Regulation II), conferred on ESMA all registration and supervision duties. The powers previously granted to the competent authorities of the Member States were terminated on that date. Hence, ESMA was entrusted since July 2011 with the responsibility for registering CRAs in the EU.

Thus, a single Member State cannot effectively block the decision to register a CRA[108]. The registration became necessary because under *art. 4* of the CRA Regulation several financial institutions, namely credit institutions, investment firms, insurance, assurance and reinsurance undertakings, undertakings for collective investment in transferable securities and institutions for occupational retirement, may only use—for regulatory purposes—credit ratings which are issued by CRAs established in the European Community and registered in accordance with the CRA Regulation.

In addition, the registration forms a condition for being recognized as an External Credit Assessment Institution (ECAI) in accordance with the Capital Requirement Directive (CRD). Where an ECAI is registered as a CRA in accordance with the CRA Regulation, "*the competent authorities shall consider the requirements of*

[106] Raquel García Alcubilla, Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation,2012.

[107] Council Regulation 513/2011, of the European Parliament and of the Council of 11 May 2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, 2011 O.J. (L 145) (EU).

[108] Within ESMA the Board of Supervisors will take the registration decision and therein the heads of the competent authority in each Member State that in principle decide by simple majority. See also de Haan & Amtenbrink, at 22.

objectivity, independence, ongoing review and transparency with respect to its assessment methodology to be satisfied." [109]

Thus, the registration replaces the "eligibility criteria" namely having "some form of validation based on historical experience", of annex 1 of the CRD in connection with paragraph 91 of Basel II[110]. Contrary to the criterion of "credibility" registration under the CRA Regulation does not require any supporting documents to proof an established standing in the international credit rating market[111].

According to *art.* 14(4) of the CRA Regulation[112], an applying CRA shall be registered if it complies with the conditions for the issuance of credit ratings set out in the regulation. The application has to be supported by documents listed in annex II of the CRA Regulation. Their main purpose is to prove that the CRA will comply with the organizational and operational requirements of annex I sec. A and B of the CRA Regulation[113]. It is therefore much easier now to be registered under the CRA Regulation than under the CRD in connection with the paragraph 91 of Basel II[114], the European credit rating market being open even to "de novo" competitors. However, some point to the fact that this liberalization may lead to registration of inexperienced CRAs that will threaten quality of credit ratings and confidence of investors.

[109] Council Directive 2009/111/EC, of the European Parliament and of the Council of 16 September 2009 Amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as Regards Banks Affiliated to Central Institutions, Certain Own Funds Items, Large Exposures, Supervisory Arrangements, and Crisis Management, art. 81(2) & 97(2), 2009 O.J. (L 302) 105.

[110] See generally Barducci & Fest, at 27-28; de Haan & Amtenbrink, at 18 (explaining that it can not be concluded that Regulation 1060/2009 replaces the procedure foreseen in the CRD).

[111] Barducci & Fest.

[112] Council Regulation 513/2011, of the European Parliament and of the Council of 11 May 2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, 2011 O.J. (L 145) (EU).Art. 14"*In order to exercise its supervisory powers effectively, ESMA should be able to conduct investigations and onsite inspections."*

[113] Id. at 109.

[114] Basel Committee on Banking Supervision International Convergence of Capital Measurement and Capital Standards A Revised Framework . Paragraph 91: *" An ECAI must satisfy each of the following six criteria: Objectivity,.. Independence,… International access,…Transparency,.. Disclosure,.. Resources Credibility*", June 2004.

In contrast to the CRD, the legislative instrument of a directly binding regulation combined with art. 14(5) [115]of the CRA Regulation determining that competent authorities shall not impose requirements regarding registration that are not provided for in the CRA Regulation, guarantee that premises to be registered as CRA are the same in all Member States.   Summarizing, ESMA was given the authority to:

- Get an access all necessary information on CRAs.
- Examine any procedures and data including telephone calls.
- Interview or summon and hear a person.
- Carry out on-site inspections at the premises of CRAs.

In the case of an breaches committed by a CRA, ESMA has the power to[116]:

- Require the CRA to bring the breach to an end.
- Suspend the use of ratings for regulatory purposes.
- Temporarily prohibit the CRAs from issuing ratings.
- Withdraw the registration.
- Impose a fine or a periodic penalty payment.

3.3.3.2 Fees on CRAs

According to Article 19 of the CRA Regulation[117], ESMA shall charge fees, which cover the costs of registration and supervision of CRAs. Article 19 requires the EC

[115] Council Regulation 513/2011, of the European Parliament and of the Council of 11 May 2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies, 2011 O.J. (L 145) (EU). Art. 14 par. 5 "*ESMA shall not impose requirements regarding registration which are not provided for in this Regulation.";*

[116] Garcia Alcubilla, Raquel; Ruiz del Pozo, Javier *"Credit Rating Agencies on the Watch List: Analysis of European Regulation"* Oxford University Press, 2012.

[117]Council Regulation 513/2011, of the European Parliament and of the Council of 11 May 2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies. Art. 19 : *ESMA shall charge fees to the credit rating agencies in accordance with this Regulation and the regulation on fees referred to in paragraph 2. Those fees shall fully cover ESMA's necessary expenditure relating to the registration and supervision of credit rating agencies and the reimbursement of any costs that the competent authorities may incur carrying out work*

to adopting the regulation has to accomplish two values : the fees collected shall fully cover ESMA's expenditure necessary for its supervisory activities; and the amount of the fees charged to individual CRAs shall be proportionate to the turnover of the CRA concerned[118]. In May 2011, ESMA published its Technical Advice to the Commission on Fees for CRAs referred to in Article 19. Following fees are issued:

- Registration.
- Certification.
- Two supervisory fees:

a) On-going supervision of registered CRAs.

b) b) Supervision of certified CRAs (ESMA, 2011).

3.3.3.3 Cooperation and Exchange of Information

The need to reinforce cooperation between supervisor authorities came out strongly from the last financial crisis. The European Legislator insisted on the relevance on ensuring an appropriate system of cooperation between all actors participating in the supervisory framework and inter-social level. Article 26 of the CRA Regulation underlines this aim with a straightforward mandate:

"ESMA, EBA, EIOPA, the competent authorities and the sectorial competent authorities shall cooperate where it is necessary for the purposes of this Regulation and for those of the relevant sectorial legislation" (EC, 2011).

pursuant to this Regulation, in particular as a result of any delegation of tasks in accordance with Article 30. 2011.

[118] Raquel García Alcubilla, Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation,2012.

The goal to achieve is ensuring the flow of appropriate and reliable information between them (Article 2.4). According to Article 32.2[119], all the information under the Regulation is confidential.[120] However, it will not be considered confidential information if the authority or body concerned states at the time of communication that such information may be disclosed or where such disclosure is necessary for legal proceedings (EC, 2009). The Regulation allows ESMA to communicate the information, if relevant for the performance of their tasks, to a limited number of authorities or bodies: the central banks, the European System of Central Banks and the ECB, in their capacity as monetary authorities, the ESRB and, where appropriate, to other public authorities responsible for overseeing payment and settlement systems. (EC, 2009) The Regulation expects such authorities to communicate to ESMA information that it may need to carry out its duties under the Regulation.

3.3.3.4 Delegation of tasks

As recognised in the recital 39 of ESMA Regulation the delegation of task can be an useful instrument of the functioning of network of supervisors to boost efficiency. Possible tasks that may be delegated include the power to carry out information requests and to conduct investigations and on-site inspections. However, Article 30.4 sets some limits on delegation: main supervisory responsibilities according to this Regulation, including registration decisions, final assessments and follow-up decisions concerning infringements, shall not be delegated (EC, 2011).

3.3.3.5 Notifications and Suspension Requests

[119]. Council Regulation 513/2011, Art. 2: "*All the information that, under this Regulation, is acquired by, or exchanged between, ESMA, the competent authorities, the sectoral competent authorities or other authorities and bodies referred to in Article 27(2), shall be considered confidential, except where ESMA or the competent authority or other authority or body concerned states at the time of communication that such information may be disclosed or where such disclosure is necessary for legal proceedings*." 2011

[120] Council Regulation 513/2011, Art. 32.1 "*The obligation of professional secrecy shall apply to ESMA, the competent authorities, and all persons who work or who have worked for ESMA, for the competent authorities or for any other person to whom ESMA has delegated tasks, including auditors and experts contracted by ESMA. Information covered by professional secrecy shall not be disclosed to another person or authority except where such disclosure is necessary for legal proceedings*."

The Regulation envisages the possibility and obligation for competent authorities to inform ESMA of breaches. The requests of competent authorities to suspend the use of the ratings for regulatory purposes of the CRAs concerned are handled based on the information provided, and if ESMA considers that the request is justified, "*it shall take the appropriate measures to resolve the issue*". However, where according to ESMA the request is not justified, it will inform the notifying competent authority in writing, setting out the reasons for not taking supervisory actions (Garcia, 2012)[121].

3.3.3.6 Cooperation with Authorities from Third Countries

ESMA may conclude cooperation agreements on exchange of information with the competent authorities of third countries for the performance of their respective tasks, according to *Article 34*. These agreements are possible if the information disclosed is subject to guarantees of professional secrecy. The common EU rules on data protection will apply in the situations where ESMA is to transfer personal data to a third country authority (EC, 2001). Article 35 mentioned , that the information may be disclosed if supervisory authority gave its agreement or where such disclosure is necessary for legal proceedings. At a global level, IOSCO provides supervisors with a multilateral forum that enables them to share information regularly as to the rules and approaches they adopt in implementing the IOSCO Code of Conduct and in regulating CRAs generally.

3.4 Regulation (EU) No 462/2013 of 21 May 2013

"It is not the thermometer that causes the fever but the thermometer has to work properly to ensure you do not exaggerate the fever."

European Internal Market Commissioner Michel Barnier, 2011.

[121]Council Regulation 513/2011, Art. 31.2 *"Where ESMA considers that the request is not justified, it shall inform the notifying competent authority in writing, setting out the reasons. Where ESMA considers that the request is justified, it shall take the appropriate measures to resolve the issue."* 2011.

Whilst providing a good basis, criticism aroused both at the European and at the international level that a number of issues related to credit rating activities and the use of ratings had not been sufficiently addressed in the existing CRA Regulation. There were weaknesses in the past EU rules on credit ratings that have been highlighted both by the financial crisis and the euro debt crisis. At the European level, the European Commission, the European Parliament, the Council of the EU, the European Securities Committee and the European Banking Committee pointed to the need to further strengthen the regulatory framework for CRAs[122]. These concerns relate notably to the risk of overreliance on credit ratings by financial market participants, the specifics of sovereign ratings, conflicts of interests with regard to high market concentration and to the issuer-pays model and CRAs' shareholder structure, threatening independence of CRAs and civil liability of CRAs vis- à-vis investors. At the international level the Financial Stability Board (FSB) issued principles to reduce authorities' and financial institutions' reliance on credit ratings[123]. (as mentioned in the second chapter).

In the following, there is a critical analysis of the main weakness of the regulation 1016/2009 with an emphasis on the interplay between ESMA and CRAs[124].

- More Transparent and More Frequent Sovereign Debt Ratings[125]: Downgrading sovereign ratings has immediate consequences on the stability of financial markets but CRAs are insufficiently transparent about their reasons for attributing a particular rating to sovereign debt. Given the importance of ratings on sovereign debts, it is essential that ratings of this

[122] *Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies*, COM (2011) 747 final (Nov. 15, 2011); *Proposal for a Directive of the European Parliament and of the Council 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 (Nov. 15, 2011).
[123] FSB, *Principles for Reducing Reliance on CRA Ratings* (Oct. 27, 2010), http://www.financialstabilityboard.org/publications/r_101027.pdf.
[124] *See generally* Press Release, European Commission, Commission Wants Better Quality Credit Ratings (Nov. 15, 2011), available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1355. (summarizing the goals of the proposed regulation).
[125] The rating of a State, a regional or local authority of a State or of an instrument for which the issuer of the debt or financial obligation is a State or a regional or local authority of a State. See generally GEORGES UGEUX, THE BETRAYAL OF FINANCE 200 (2011), at 193-196 (discussing the legitimacy of sovereign rating).

asset class are both timely and transparent. While the EU regulatory framework for credit ratings already contains measures on disclosure and transparency that apply to sovereign debt ratings, further measures are needed such as access to more comprehensive information on the data and reasons underlying a rating, in order to improve the process of sovereign debt ratings in EU;

Therefore, further measures was needed such as access to more comprehensive information on the data and reasons underlying a rating, in order to improve the process of sovereign debt ratings in EU;

- investors' over-reliance on ratings: European and national laws give a quasi-institutional role to ratings. For example, the amount of capital that banks must hold is determined in some cases by the external ratings given to it. Furthermore, some investors rely excessively on the opinions of CRAs, and don't have access to enough information on the debt instruments rated or the reasons behind the credit rating which would enable them to conduct their own credit risk assessments. Measures were needed to reduce references to external ratings in legislation and to ensure investors carry out their own additional due diligence on a well-informed basis;

- conflicts of interest threaten independence of CRAs and high market concentration: this specific matter is particularly related to the issuer-pay business model. CRAs are not independent enough from the rated entity that contracts (and pays) them: e.g. as a rating agency has a financial interest in generating business from the issuer that seeks the rating, this could lead to assigning a higher rating than warranted in order to encourage the issuer to contract them again in the future. Furthermore, a small number of large CRAs dominate the market. The rating of large corporates and complex structured finance products is conducted by a few agencies that also happen to have shareholders that sometimes overlap;

- (absence of) liability of CRAs: CRAs issuing credit ratings in violation of the CRA Regulation are not always liable towards investors that suffered losses. National differences in civil liability regimes could result in credit rating agencies or issuers shopping around, choosing jurisdictions under which civil liability is less likely.

The aim of the Regulation (EU) No 462/2013 of 21 May 2013 was to amend the latter regulation (in order to resolve the demonstrated weakness in this specific field).

Main elements of new rules embedded in CRA III:

- **Two credit ratings required for rated structured finance instruments**

Where an issuer or a related third party[126] intends to solicit a credit rating for a structured finance instrument[127], it is required to appoint at least two independent CRAs.

This requirement will apply only to new transactions and transactions where a new credit rating is sought, as it applies where an issuer or related third party "intends to solicit" a credit rating. There are some questions over the jurisdictional scope of this provision.

Since the majority of rated securitisation transactions have two ratings, this requirement should not in itself be a significant issue for those transactions

[126] "related third party" means "the originator, arranger, sponsor, servicer or any other party that interacts with a credit rating agency on behalf of a rated entity, including any person directly or indirectly linked to that rated entity by control".

[127] "structured finance instrument" is defined in the CRA Regulation as "a financial instrument or other assets resulting from a securitisation transaction or scheme referred to in Article 4(36) of Directive 2006/48/EC". Under Article 4(36) of Directive 2006/48/EC, "securitisation" means "a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranced, having the following characteristics:
(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and;
(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme."

(although note the requirement to consider appointing a small CRA which is described below). However, this requirement is likely to lead to additional transaction costs in some cases, and the question might be posed as to how this requirement fits within the aim of decreasing reliance on ratings.

- **Requirement to consider appointing small CRAs**

Where an issuer or a related third party intends to appoint at least two CRAs to provide a credit rating for the same issuance or entity, it is required to consider appointing at least one CRA with no more than 10% of the total market share [128](a "Small CRA") that is capable of rating the relevant issuance or entity. ESMA will publish a list of registered CRAs on an annual basis. If a Small CRA is not appointed, this is required to be documented.

The recitals to CRAIII indicate that these measures are intended to increase competition in the credit ratings market, which has been dominated by Moody's, Standard & Poor's and Fitch, and to encourage the use of smaller CRAs. The extent to which market participants find that there are sufficient Small CRAs able, and with the relevant experience, to provide the relevant ratings remains to be seen.

- **Joint disclosure requirements in relation to structured finance instruments**

The issuer, originator and sponsor [129] of a structured finance instrument established in the European Union will be required, jointly, to publish information in relation to:

- the credit quality and performance of the underlying assets;

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[128] Total market share of the relevant CRA is to be measured with reference to annual turnover generated from credit rating activities and ancillary services, at group level.

[129] "issuer" is defined in CRA3 by reference to the definition in Article 2(1)(h) of Directive 2003/71/EC, i.e. "a legal entity which issues or proposes to issue securities". "originator" is defined in CRA3 by reference to the definition in point (41) of Article 4 of Directive 2006/48/EC, i.e. "either of the following: (a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them".
"sponsor" is defined in CRA3 by reference to the definition in point (42) of Article 4 of Directive 2006/48/EC, i.e. "a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities".

- the structure of the securitisation transaction;
- the cash flows; and
- any collateral supporting a securitisation exposure,

together with any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures (the "Joint Disclosure Requirements"). Such information is to be published on a website which is to be established by ESMA. The Joint Disclosure Requirements do not require information to be disclosed where this would breach national or EU law in relation to confidentiality or the processing of personal data[130].

The aim of this measure is to improve the ability of investors to make an informed assessment of the creditworthiness of structured finance instruments, thereby reducing their reliance on credit ratings. It is also expected that the publication of such information will reinforce competition between CRAs by encouraging unsolicited credit ratings.

The Joint Disclosure Requirements are in addition to the disclosure requirements under the Prospectus Directive[131] (which apply in relation to prospectuses), Article 122a[132] (which apply only to sponsor and originator credit institutions) or Article 409 of CRD IV [133] (which apply only to sponsors and originators who are credit institutions or investment firms), and the reporting requirements for eligible collateral under the liquidity schemes put in place by the Bank of England and the

[130] Regulation (EU) No 462/2013 of 21 May 2013. Article 8b(2) *"The obligation under paragraph 1 to publish information shall not extend to where such publication would breach national or Union law governing the protection of confidentiality of information sources or the processing of personal data."*

[131] Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

[132] Article 122a was added to the Capital Requirements Directive (Directive 2006/48/EC and Directive 2006/49/EC) by Directive 2009/111/EC of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management.

[133] Directive 2013/36/EU on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and the regulation on prudential requirements for credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (the "CRR"). Articles 404-410 of the CRR will replace the previous risk retention provisions under Article 122a of Directive 2006/48/EC with effect from 1 January 2014.

European Central Bank, as well as the disclosure obligations imposed under Rule 17g-5[134]. The details of what is required are embedded in the publication of draft regulatory technical standards ("RTS")[135].

Additionally, on 10 July 2013, ESMA published a Discussion Paper (the "Discussion Paper") requesting comments from market participants in preparation for drafting various RTS required under CRA3, including the RTS for the Joint Disclosure Requirements[136].

After the Discussion paper, the European Commission has adopted a final regulation that sets out wide-ranging disclosure requirements for structured finance instruments ("SFIs") in circumstances where the issuer, originator or sponsor is established in the European Union ("EU").

Although the disclosure requirements apply only to structured finance instruments issued on or after 1 January 2017, or outstanding on that date, the disclosure requirements will apply to a broad range of transactions, including unrated and—after a phase-in period—private and bilateral structured finance instruments.

On 30 September 2014, the European Commission adopted three Regulatory Technical Standards (RTS) to implement provisions of the EU Regulation on Credit Rating Agencies ("CRA3")[137]. These Regulatory Technical Standards establish:

- Disclosure requirements for issuers, originators and sponsors of structured finance instruments,
- Reporting requirements in relation to the European Rating Platform, and
- Reporting requirements on fees charged by credit rating agencies.

[134] Rule 17g-5 under the United States Exchange Act of 1934, as amended
[135] ESMA publishes draft RTS on CRA3 transparency requirements, n. 2014/689, 24/06/2014.
[136] Discussion Paper on CRA Implementation, 10 July 2013, ESMA/2013/891, which can be found at http://www.esma.europa.eu/system/files/2013-891_discussion_paper_on_cra3_implementation.pdf
[137] The EU Regulation on Credit Rating Agencies (Regulation (EC) No 1060/2009), in force since 2010, was amended in May 2011 and further amended with effect from 20 June 2013 ((IP/13/555).

The stated aim of the RTS is to improve the ability of investors to make an informed assessment of the creditworthiness of SFIs, thereby reducing investors' dependence on credit ratings and reinforcing competition between credit rating agencies. The RTS specify:

- The information that the issuer, originator and sponsor of an SFI established in the European Union must jointly disclose on a website (the "SFIs website") to be set up by the European Securities and Markets Authority ("ESMA")[138];
- The frequency with which this information is to be updated[139]; and
- The presentation of this information by means of standardised disclosure templates.

- **Reduction of reliance on credit ratings**

Financial institutions

[138] Regulatory Technical Standards under the CRA3 Regulation: General requirements: The reporting entity is required to provide the following information to the SFIs website: Loan-level information using standardised disclosure templates set out in the RTS.
The following documents, where applicable to a SFI, including a detailed description of the payments waterfall: The final offering document or prospectus, together with the closing transaction documents including any public documents referenced in the prospectus, or which govern the workings of the transaction but excluding legal opinions; The asset sale agreement or other applicable transfer document; The servicing, administration and cash management agreement; The trust deed, security deed, agency agreement, account bank agreement, guaranteed investment contract, incorporated terms memorandum or master framework agreement; Any relevant inter-creditor agreements, swap documents, subordinated loan agreements, start-up loan documents and liquidity facility agreements; and Any other underlying documents that are essential for the understanding of the transaction.
If a prospectus has not been drawn up, a transaction summary or overview of the main features of the SFI, including: Deal structure; Asset characteristics, cash flows, credit enhancement and liquidity support features; Noteholder voting rights and the relationship between noteholders and other secured creditors; A list of all triggers and events that could have a material impact on the performance of the SFIs; and Structure diagrams containing an overview of the transaction, the cash flows and the ownership structure. Investor reports containing specified information.
[139] The specified loan-level information and investor reports have to be made available on a quarterly basis, no later than one month following the interest payment date on the SFI. The information specified above has to be made available without delay after the issuance of an SFI. In addition, where the market abuse regime applies to an SFI, any disclosure of information under that regime also has to be published without delay on the SFIs website by the reporting entity. Where the market abuse regime does not apply, the reporting entity is required to disclose without delay on the SFIs website any significant change or event relating to: (i) a breach of the obligations in the transaction documents; (ii) structural features that can materially affect the performance of the SFI; and (iii) the risk characteristics of the SFI and of the underlying assets.

CRA3 includes a new provision requiring credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties (together, "Financial Institutions") to make their own credit risk assessment and not to rely solely or mechanistically on credit ratings for assessing the creditworthiness of an entity or financial instrument.

The intention is that credit institutions and investment firms should put in place internal procedures in order to make their own credit risk assessment and encourage investors to carry out due diligence. The recitals to CRAIII[140] also state that financial institutions should avoid using credit ratings in contracts as the only parameter to assess the creditworthiness of investments or to decide whether to invest or divest.

National supervisory authorities are required to monitor the adequacy of the credit risk assessment processes of Financial Institutions, assess the use of contractual references to credit ratings and encourage Financial Institutions to mitigate the impact of such references, with a view to reducing sole and mechanistic reliance on credit ratings.

Therefore the Regulation is complemented with amendments in sectoral legislation. Specifically, the package contains a Directive which amends current directives on the activities and supervision of institutions for occupational retirement provision (IORP [141]) undertakings of collective investment in transferable securities (UCITS) [142] and on alternative investment funds managers (AIFM) [143] in order to reduce these funds' reliance on external credit ratings when assessing the creditworthiness of their assets.

[140] Regulation (EU) No 462/2013. Article 5(a) "*The entities referred to in the first subparagraph of Article 4(1) shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument".*

[141] Directive 203/41/EC 15 Institutions for occupational retirement provision.

[142] Directive 2009/65/EC Undertakings for collective investment in transferable securities.

[143] Directive 2011/61/EU Alternative investment fund managers.

European Supervisory Authorities and the European Systemic Risk Board

The European Banking Authority ("EBA"), the European Insurance and Occupational Pensions Authority ("EIOPA") and ESMA are now prohibited from referring to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings. Similar requirements apply to the European Systemic Risk Board in relation to its warnings and recommendations. EBA, EIOPA and ESMA are required to review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations by 31 December 2013.

EU law

The European Commission will continue to review whether references to credit ratings in EU law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings, with a view to removing all references to credit ratings in EU law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and put in place[144].

These new requirements are in line with the principles drawn up at the international level by the Financial Stability Board, which aim to reduce reliance on CRA ratings in standards, laws and regulations[145].The principles state that wherever possible, references to such ratings should be removed or replaced with suitable alternative standards of creditworthiness assessment and that banks, investment managers and institutional investors should not mechanistically rely on external credit ratings for assessing the creditworthiness of assets but should make their own credit assessments. This is also consistent with the aim of reducing over-reliance on external credit ratings described in CRD IV and the proposals by the Basel

[144] Regulation (EU) No 462/2013. Article 5(c). "*Without prejudice to its right of initiative, the Commission shall continue to review whether references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities, the entities referred to in the first subparagraph of Article 4(1) or other financial market participants with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and implemented*".

[145] Principles for Reducing Reliance on CRA Ratings, published by the Financial Stability Board on 27 October 2010, which can be found here http://www.financialstabilityboard.org/publications/r_101027.pdf.

Committee on Banking Supervision to reduce over-reliance on CRA ratings in the regulatory capital framework.[146] However, in the case of CRAIII, the removal of references to credit ratings is conditional upon identifying and implementing appropriate alternatives.

- **Rotation in relation to re-securitisations**

A long relationship between a CRA and an issuer could undermine the independence of a CRA and in view of the issuer pays model lead to an important conflict of interest that could affect the quality of these ratings. To this end the rotation rule limits the duration between a CRA an issuer. While the Commission proposed a broader scope, the Regulation limits the rotation rule to re-securitisations. This can be seen as an important way to test the effectiveness of the rotation rule. By end 2016, the Commission will report back to the European Parliament on the effectiveness of the rotation rule with a view to extending the scope if appropriate. Going deeper, where a CRA has entered into a contract for the issuance of credit ratings in relation to re-securitisations[147],that CRA will not be permitted to issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years from the date of entry into the contract (the "Maximum Ratings Period")[148]. There is an exemption where at least four CRAs each rate more than 10% of the total number of outstanding re-securitisations with underlying assets from the same originator (the "Multiple Rating Agencies Exemption"). In addition, the rotation requirements do not apply to CRAs with fewer than 50 employees at group level involved in credit rating activities or with an

[146] As illustrated, for example, by the proposed revisions to the Basel securitisation framework which are intended to mitigate mechanistic reliance on external credit ratings, as described in the consultative paper entitled "Revisions to the Basel Securitisation Framework" which was published in December 2012 and can be found here http://www.bis.org/publ/bcbs236.pdf. See the Cadwalader Clients & Friends Memo entitled "What's Next for the Basel Securitisation Framework?" for more information: http://www.cadwalader.com/assets/client_friend/050913WhatsNextfortheBaselSecuritisationFramework.pdf

[147] "re-securitisation" is defined in CRAIII by reference to the definition in point (40a) of Article 4 of Directive 2006/48/EC. Such definition was included in that Directive under Directive 2010/76/EU of 24 November 2010, which added the following definition of "re-securitisation": "a securitisation where the risk associated with an underlying pool of exposures is tranced and at least one of the underlying exposures is a securitisation position".

[148] Regulation (EU) No 462/2013. Article 6b(1). *"Where a credit rating agency enters into a contract for the issuing of credit ratings on re-securitisations, it shall not issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four year."*

annual turnover generated from credit rating activities of less than €10 million at group level.

Following the expiry of a contract for the rating of re-securitisations, the relevant CRA is not permitted to enter into a new contract for the issuance of credit ratings on re-securitisations with underlying assets from the same originator for a period equal to the duration of the expired contract (but not exceeding four years) (the "Non-Ratings Period"). In spite of these requirements, a CRA is still permitted to monitor and update credit ratings which it has issued in relation to re-securitisations before the end of the Maximum Ratings Period.

While the CRA Regulation already included a rotation mechanism in relation to individuals in analytical teams and credit rating committees, this was not considered to be a sufficient guarantee against possible conflicts of interest from long-standing relationships with CRAs, and consequently it was thought necessary to bring in a rotation mechanism for the CRAs themselves. It is acknowledged in the recitals to CRAIII that frequent rotation could result in increased costs for both issuers and CRAs (since the cost of a new rating is typically higher than for ongoing monitoring of a rating). It is also recognised that it can take time and resources for new CRAs to be established and that rotation could have "a significant impact on the quality and continuity of credit ratings". However, the intention is that rotation should lead to greater diversity in, and consequently improve, the credit assessment process.

Although many market participants may dislike the concept of rotation, it is possible to note that the rotation requirements for CRAs have been watered down from the original proposals, which included different time periods and were not limited to re-securitisations. Market participants may regard the final rule as a better outcome, particularly as it appears likely that its application may be less widespread owing to potentially reduced interest in entering into re-securitisation transactions following the financial crisis, due to their perceived complexity and punitive risk weights for regulatory capital purposes[149] (although care will need to be taken to check whether

[149] See the Cadwalader Clients & Friends Memo entitled "What's Next for the Basel Securitisation Framework?" which summarises the treatment of re-securitisation exposures under the proposed revisions

a transaction could unintentionally fall into the re-securitisation definition). The rotation requirements have been applied to re-securitisations in the first instance on the basis that this class of securitisation transactions has underperformed since the financial crisis and therefore this is where the need to address conflicts of interest is greatest.

For re-securitisations, the parties will need to find suitable replacement CRAs at the end of the relevant Maximum Ratings Period and will need to allow time for the replacement CRAs to analyse the transaction. Additionally, there may be a risk of fluctuations in ratings since the replacement CRAs may well assess the transaction using different methodologies and it is likely that the rotation requirements will lead to increased transaction costs.

- **European rating platform**

All credit ratings, rating outlooks and other relevant information for EU registered and authorised rating agencies will be published on the central European Rating Platform, at the European Securities and Markets Authority (ESMA), which will improve the visibility and comparability of credit ratings from debt instruments. This is intended to allow investors to compare all credit ratings (except for credit ratings provided under the "investor-pays" model) and to allow smaller and new CRAs to gain more visibility. Therefore the Platform gives the opportunity increase the visibility of small and medium-sized credit rating agencies operating in the EU.

✓ **Advance notice of publication of ratings**

CRAs are now required to notify a rated entity of any change to a credit rating or rating outlook within working hours and at least one full working day before

to the Basel securitisation framework referred to in footnote 17 above. This Clients & Friends Memo can be found at http://www.cadwalader.com/assets/client_friend/050913WhatsNextfortheBaselSecuritisationFramework.pdf.

publication, to allow the rated entity to draw the relevant CRA's attention to any errors[150].

- **Sovereign ratings**

Sovereign debt ratings are important and the implications of such ratings can in some circumstances be far-reaching. Not only do they affect the borrowing costs of Member States but they can also have further implications for other Member States and the financial stability of the Union as a whole. However, a prohibition of sovereign debt ratings could give the impression that Member States had something to hide and therefore it is not part of the new rules[151]. A prohibition could have important effects for the access to capital of some Member States and could increase the borrowing cost for sovereign debt. The Commission considers that this Regulation improves considerably the transparency of sovereign ratings and will avoid negative effects of sovereign ratings which have been observed in recent years and stop risks of market disruption. While CRAs have an obligation to review their credit ratings on an ongoing basis and at least annually, they will now be required to review sovereign ratings at least every six months. To avoid market disruption, rating agencies will set up a calendar indicating when they will rate Member States. CRAs are required to publish a calendar in December for the following 12 months setting out a maximum of three dates for the publication of unsolicited sovereign ratings and rating outlooks and setting the dates for the publication of solicited sovereign ratings and rating outlooks. Those dates must be set on a Friday and deviation from those dates is permitted only in certain specified circumstances.

- **Advance notice of changes to rating methodologies**

A CRA that intends to change materially existing or use any new rating methodologies, models or key rating assumptions that could have an impact on a

[150] Previously, CRAs had to inform the relevant rated entity at least 12 hours before publication of the credit rating

[151] Regulation (EU) No 462/2013. Article 8a(1) "*Sovereign ratings shall be issued in a manner which ensures that the individual specificity of a particular Member State has been analysed. A statement announcing revision of a given group of countries shall be prohibited if it is not accompanied by individual country reports. Such reports shall be made publicly available*"

credit rating will need to publish the proposed changes or proposed new methodologies on its website inviting stakeholders to submit comments during a period of one month together with a detailed explanation of the reasons for and the implications of the proposed material changes or proposed new methodologies. A CRA will need to inform ESMA of errors detected in methodologies and/or their application.

- **Liability**

The liability issue is subject to an unprecedentedly intense regulatory debate in the rating industry. Only recently the European Commission has put forward a proposal for a regulation (CRAIII), which was adopted by the European Parliament on January 16, 2013, to amend and reinforce the 2009 version of the EU Rating Regulation, among other things imposing civil liability on the agencies. Article 35a of the amendment of the EU Rating Regulation introducing civil liability of credit rating agencies has been one of the most controversial provisions of the amendment. Ratings are not mere opinions but have important consequences. Therefore, CRAs should operate responsibly. The regime does not aim to address "wrong ratings". Investors will only be able to sue a credit rating agency cause damage to investors. This new regime will ensure that rating agencies will act more responsibly as they can be held liable by investors and issuers. If a CRA commits an infringement under Annex III of the CRA Regulation, either intentionally or with gross negligence, which has an impact on a credit rating, an investor or an issuer may claim damages if:

i. in the case of an investor, it can establish that it reasonably relied on such credit rating; or

ii. in the case of an issuer, it or its financial instruments are covered by such credit rating and the infringement was not caused by misleading or inaccurate information provided by such issuer.

In the European Member States there is no specific legislation governing contracts between issuers and credit rating agencies, so that the general rules of contract law will apply in full. As a result, one has to overcome some major obstacles in order to hold rating agencies liable for breach of contract. The civil liability provisions of the CRA Regulation provide that terms which are not defined therein should be interpreted and applied in accordance with the applicable national law. As far as the UK is concerned, the Credit Rating Agencies (Civil Liability) Regulations 2013, which came into force on 25 July 2013, define certain terms used in the civil liability provisions and also set out certain factors which a court may consider in relation to whether limitations on liability are reasonable and proportionate, the general approach to determining damages, which will be subject to a duty to mitigate, and a limitation period.[152]

It is apparent that, even though CRAIII and other new legislation in the EU and in the US as well have the aim of reducing investors' reliance on ratings, CRAs could be subject to civil liability claims resulting from breaches of their obligations under Annex III of the CRA Regulation (which are extensive). While there may be some who will welcome these changes, the new provisions will be of concern to CRAs and may restrict the availability of ratings.

- **Independence and avoidance of conflicts of interest due to shareholdings**

CRAIII contains further provisions aimed at ensuring the independence of CRAs and the avoidance of conflicts of interest, by requiring effective internal control structures governing the implementation of policies and procedures to address these matters and by prohibiting shareholders or members with 5% or more of the capital or voting rights in a CRA from holding 5% or more of the capital or voting rights or exercising control over any other CRA.

In addition, a CRA is not permitted to issue a credit rating or rating outlook if a shareholder or member of a CRA holding 10% or more of the capital or voting rights of the CRA, or with significant influence on its business activities, holds 10%

[152] SI 2013/1637, which can be found at http://www.legislation.gov.uk/uksi/2013/1637/pdfs/uksi_20131637_en.pdf.

of more of the capital or voting rights of the rated entity, a related third party or an ownership interest in any such entity.

- **Future review of the CRA Regulation**

The European Commission is required to report to the European Parliament and the European Council on various issues arising from the CRA Regulation, including:

i. by 31 December 2013, on the feasibility of a network of smaller CRAs in order to increase competition in the market, including evaluation of financial and non-financial support for such a network, taking into account potential conflicts of interest arising from public funding. This may lead to re-evaluation and amendment of the requirement to consider appointing at least one Small CRA, as described above;

ii. by 31 December 2014, on the appropriateness of the development of a European creditworthiness assessment for sovereign debt;

iii. by 31 December 2015, on the steps taken regarding the removal of references to credit ratings which trigger or have the potential to trigger sole or mechanistic reliance on credit ratings, and alternative tools to enable investors to make their own credit risk assessments, with a view to deleting all references to credit ratings in EU law for regulatory purposes by 1 January 2020;

iv. by 1 July 2016, on:

    - the availability of sufficient choice to comply with the requirement to appoint at least two CRAs when soliciting a credit rating;

    - whether the Joint Disclosure Requirements should be extended to any other financial credit products;

    - the availability of sufficient choice to comply with the rotation requirements in relation to re-securitisations;

- whether the Maximum Ratings Period and the Non-Ratings Period in relation to the rotation requirements for re-securitisations should be shortened or extended;
- whether the Multiple Rating Agencies Exemption should be amended;
- whether the scope of the rotation mechanism should be extended to other asset classes and whether different periods should be applicable for various asset classes;
- whether various provisions such as those intended to avoid conflicts of interest have sufficiently mitigated such conflicts of interest; and
- whether there is a need to propose measures to address contractual over-reliance on credit ratings; and

v. by 31 December 2016, on the appropriateness and feasibility of supporting a European CRA for assessing the creditworthiness of the sovereign debt of Member States and/or a European credit rating foundation for all other credit ratings.

Clearly, the European regulatory framework in relation to credit ratings remains under continued review and it is highly likely that there will be further developments.

4 US REGUATION

Regulations in the United States are based on a very long history reaching back to the beginning of the twentieth century. U.S. Regulations have been iteratively revised during this period and parts of it are used in several international frameworks. The relevant regulations in the U.S. are characterized according to the first two types of regulations as described above:

a) Regulations concerning the regulatory use of CRA. US regulation became entangled with credit ratings during the 1930s, in response to the 1929 market crash. The “Office of the Comptroller of the Currency” (OCC) released the first regulation concerning minimum capital requirements in the United States in 1931 and the Federal Reserve followed in 1935 and 1936. This was the first time an official regulator used the differentiation between investment-grade and speculative-grade rating by ruling, that bank holdings had to be rated above BBB – otherwise bonds had to be written down to market value. Several analogue regulations followed (e.g. the prohibition of < BBB rated bonds by the FED in 1936) and are still valid today. The regulation was aimed to increase stability on the U.S. bond market but also had a side-effect that shaped the market of credit rating agencies till today: With the requirement of minimum rated bonds, the demand for credit ratings increased dramatically. Between the 1930s and the 1970s the use of ratings in regulation did not change significantly.

b) Regulations concerning the recognition of CRAs.
Until 1975, any credit rating agency could be used to determine the rating of issuers or bonds, which caused several problems – among other things – in regards to the rating quality. The SEC addressed this problem by defining the NRSRO category for national credit rating agencies (SEC, 1975).. With the introduction of this category, only credit ratings of CRAs that where “national recognized statistical rating organizations” could be used by banks to determine their specific minimum capital requirements. In 1975, only three CRA were recognized as NRSRO: Moody’s, Standard and Poor and Fitch. This regulation was criticized heavily as there was no formal criteria defined, how NRSRO recognition could be achieved. This issue was resolved not until 2006, when the Credit Rating Reform Act passed congressional approval: “The act provided the SEC with explicit legal authority to require rating agencies electing to be treated as NRSROs to register with it (thereby opening a clear path of entry for new competitors) and to comply with certain requirements“[153]. Although the law regarding NRSRO recognition was

[153] The World Bank : *Credit Rating Agencies – No Easy Regulatory Solution*. Washington D.C.: The World Bank Group. 2009.

changed several times between 1975 and 2006 it created market entry barriers and a de-facto oligopoly on the credit rating market.[154]

However, going back before 1975, the SEC worried that references to "recognized rating manuals" were too vague and that a "bogus" rating firm might arise that would promise "AAA" ratings to those companies that would suitably reward it and "DDD" ratings to those that would not. If a broker-dealer claimed that those ratings were "recognized," the SEC might have difficulties challenging this assertion. To solve this problem, the SEC designated Moody's, S&P, and Fitch as "Nationally Recognized Statistical Rating Organizations" (NRSROs)[155]. In effect, the SEC endorsed the ratings of NRSROs for the determination of the broker-dealers' capital requirements. The ratings had the force of law with respect to regulated financial institutions' abilities and push (via capital requirements) investment decisions, in particular it incentives the bond market (at the beginning only the bond instrument was rated) . Over the next 25 years, the SEC designated only four additional firms as NRSROs[156], but mergers among the entrants and with Fitch reduced the number of NRSROs to the original three by the end of 2000. NRSRO designation had become a significant barrier to entry into the bond-rating business because the SEC's support was quite important for potential entrants. Moreover, as explained above, the SEC neither established criteria for a NRSRO designation nor provided any justification or explanation as to why it "anointed" some firms with the designation and refused to do so for others.

Also importantly, in place of the "investor pays" model established by John Moody in 1909, the agencies converted to an "issuer pays" model during the early 1970s whereby the entity that is issuing the bonds also pays the rating firm to rate the bonds, opening the door to potential conflicts of interest.

[154] White, L. J: The Credit Rating Industry: An Industrial Organization Analysis, *New York University*, EC-01-02, 2001.
[155] "Commodity and Securities Exchanges," Title 17, *Code of Federal Regulations*, section 240.15c3-1 (1998). Also, in the early 1990s, the SEC again made use of the NRSROs' ratings when it established safety requirements for the short-term bonds (e.g., commercial paper) that are held by money-market mutual funds.
[156] The SEC bestowed the NRSRO designation on Duff & Phelps in 1982; on McCarthy, Cristanti & Maffei in 1983; on IBCA in 1991; and on Thomson Bank Watch in 1992.

In the bond-information market, experience, brand-name reputation, and economies of scale are important features. The industry was never going to be a commodity business of thousands (or even hundreds) of small-scale producers. Nevertheless, regulators' actions surely contributed heavily to the dominance of the three major rating agencies. The SEC's belated efforts to allow wider entry into the NRSRO category during the current decade were too little and too late[157]. The entrants could not quickly overcome the gained advantages of the "big three's" incumbency. The major issues raised later. To a large extent, subprime lending fuelled the U.S. housing boom that began in the late 1990s and ran through mid-2006.[158] The securitization of the subprime mortgage loans, in collateralized debt obligations (CDOs) and other mortgage-related securities, encouraged subprime lending and led to the development of other financing structures, such as "structured investment vehicles" (SIVs), whereby a financial institution might sponsor the creation of an entity that bought tranches of the CDOs and financed its purchase by issuing short-term "asset-backed" commercial paper (ABCP). If rating agencies rated the CDO tranches in an SIV favourably, that favourable rating concomitantly meant high ABCP ratings (interest-rate risk and liquidity risk were apparently ignored in the ratings). Hence, the agencies' favourable ratings of mortgage-related securities were crucial for the securitization process. This is not particularly complicated understand the importance of CRAs and ,therefore, new strictly rules was necessary. In the wake of Enron, the 2002 Sarbanes-Oxley Act required the SEC to re-examine the "role and function of rating agencies in the operation of the securities market" and to

[157] The Sarbanes-Oxley Act of 2002 included a provision that required the SEC to send a report to Congress on the credit rating industry and the NRSRO system. The report simply raised questions rather than addressing the issues. In early 2003, the SEC designated a fourth NRSRO (Dominion Bond Rating Services, a Canadian firm), and in early 2005 the SEC designated a fifth NRSRO (A.M. Best, an insurance-company rating specialist). Congress later passed the Credit Rating Agency Reform Act (CRARA) in 2006. The act instructed the SEC to cease being a barrier to entry and specified the criteria for designating new NRSROs. In response to the legislation, the SEC designated three new NRSROs in 2007 (Japan Credit Rating Agency; Rating and Information, Inc. [of Japan]; and Egan- Jones) and another two NRSROs in 2008 (Lace Financial and Realpoint). There are currently ten NRSROs

[158] The debacle is discussed extensively in Gary Gorton, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007* (National Bureau of Economic Research, 2008); Viral Acharya and Matthew Richardson, "Causes of the Financial Crisis" *Critical Review: A Journal of Politics and Society* 21, nos. 2–3 (2009); Joshua Coval, et al., "The Pricing of Invest ment Grade Credit Risk during the Financial Crisis" (preliminary paper, USC Business School, 2009); and Mayer, et al., "The Rise in Mortgage Defaults: Facts and Myths" *Journal of Economic Perspectives* 23, no. 1 (2009).

specifically address potential barriers to entry[159]. According to the SEC, most of the 46 comments responding to the 2003 Concept Release supported continuing the NRSRO designation and expressed concern that "eliminating the NRSRO concept would be disruptive to capital markets.[160]" This opinion in favour of keeping the NRSRO designation was a "Letter from Leo C. O'Neill, President, Standard & Poor's, to Jonathan G. Katz, Secretary, Commission (July 28, 2003)[161]."

From these comments, the SEC attempted to clarify the process of identifying NRSROs with a proposed definition[162]:

i. issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;

ii. is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and

iii. uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of non-public information, and has sufficient financial resources to ensure compliance with those procedures.

The non-NRSRO CRA community expressed concern that these proposed reforms would, in fact, strengthen incumbent power in the market rather than reduce barriers to entry. First, the proposed rules would require CRAs to provide public credit ratings, although this would be essentially offering their products free of charge for subscriber-based CRAs. The rule clearly catered to the firms that used an issuer-

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[159] U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Ratings Agencies in the Operation of the Securities Markets.2002

[160] U.S. Securities and Exchange Commission, "Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization," Federal Register 70, no. 78 (2005): 21306–21323.

[161] Ibid. See also, Securities and Exchange Commission, "Comments on Proposed Rule: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," http://www.sec.gov/rules/concept/s71203.shtml; and Leo C. O'Neill, letter to Jonathan G. Katz, July 28, 2003, http://www.sec.gov/rules/concept/s71203/standard 072803.htm.

[162] U.S. Securities and Exchange Commission, "Proposed Rule: Definition of Nationally Recognized Statistical Rating Organization." 2005.

pays business model rather than a subscriber-pays model. Second, the requirement for CRAs to be "generally accepted" created something like a chicken-and-egg problem for new firms.

As Banking, Housing, and Urban Affairs Committee Chairman Sen. Richard Shelby put it, "to receive the license a firm must be nationally recognized, but it cannot become nationally recognized without first having the license.[163]" Ultimately, the SEC did not move forward with these proposals. In 2005, the House considered legislation to reduce barriers to entry in the CRA market, and on September 29, 2006, President Bush signed the Credit Rating Agency Act of 2006. A primary result of the legislation was to reduce arbitrary SEC power to designate NRSROs and instead set timelines for SEC response. Under the 2006 law, any credit rating firm issuing ratings for at least three years could apply to the SEC to receive the NRSRO designation. The SEC would need to render a decision or set a timeline for evaluation within 90 days, and make a final decision within 120 days. Thereafter, the Credit Rating Agency Reform Act of 2006 (US Congress, 2006) aimed at these objectives by granting rule-making, supervisory and enforcement powers to the SEC in order to oversee the credit rating industry, which was previously unregulated. Analysing the provisions in detail, the reform sets out a number of obligations that rating agencies are required to comply. Rating agencies that wish to be recognised as NRSRO apply to the SEC, furnishing information on: 1) ratings' performance 2) procedures and methodologies to calculate ratings 3) policies to safeguard confidential information 4) organisational structure 5) code of ethics 6) conflicts of interest 7) 20 largest clients 8) and written certifications on the part of "qualified institutional buyers" stating that they have used the agency for at least 3 years.

The SEC may revoke or suspend the license if the CRA no longer satisfies the criteria of the initial application or in case of misuse of non-public information and/or infringement of conflicts of interest provisions. Moreover, it can impose sanctions if the NRSRO fails to maintain adequate financial and managerial resources. The NRSRO has to submit updates on the information delivered in case

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[163] Langohr, H, and Langohr, P, "*The Rating Agencies and their Credit Ratings*", 2009.

of any change as well as an annual report certifying the accuracy of the information. The statute explicitly forbids the SEC from issuing rules concerning the substance and the methodologies of the ratings. In fact, the law ensured that neither the SEC nor the state could regulate credit ratings' content, procedures, or methodologies, and prohibited NRSROs from allowing conflicts of interest to impact rating integrity or "conditioning ratings . . . on an issuer's purchasing other services from the NRSRO[164]." The SEC's rule-making powers relate to: the prevention of misuse of non-public information; the management and disclosure of conflicts of interest; and the avoidance of unfair, coercive or abusive competitive practices. The Act also mandates that each NRSRO designate a compliance officer, and that it provide a confidential financial statement to the SEC**.** Based on the authority granted by the Credit Rating Agency Reform Act of 2006, the SEC proposed six rules on 2 February 2007, adopting the final rules on 23 May 2007. The final rules determine the details of the application process, and they establish that a NRSRO should keep a record of rating actions, internal documents, auditing materials, and internal and external communications. The NRSRO or its employees should not use confidential information for personal profit, and the NRSRO should set policies and procedures to manage and disclose conflicts of interest defined as (1) issuer-pays model (2) ancillary services (3) subscriber-pays model (4) employee owns any stake in a company rated by another employee (5) excessive involvement of an employee with the entity subject to rating. NRSROs should not (1) rate an entity whose business represents more than 10% of its total net revenue (2) rate an entity if the NRSRO or an employee involved in the rating decision own any stake in the company rated (3) rate an entity associated with themselves. As far as unfair, coercive, or abusive practices are concerned, a NRSRO should not tie the performance of its services to the purchase of other services, and should consistently use its present procedures and methodologies independently from the services purchased by the rated entity (SEC, 2007).

[164] Ibid

Barriers to entry alone were not solely responsible for problems in market structure. Instead, regulatory dependence on NRSRO ratings also led to distorted incentives and outcomes. As a result, policymakers have considered reducing the role of NRSRO ratings. The Dodd-Frank Act attempts to address the quality of ratings via a variety of mechanisms. The most extensive of these are found in Section 932.

The primary focus of Dodd-Frank's changes to the regulation of rating agencies is in trying to close off the agencies from conflicts of interest, real or perceived.

In fact, Dodd-Frank requires improved "internal controls" for the ratings process, separating the sales and marketing functions of the agencies from the ratings process, increasing the number of independent directors on the agencies' boards of directors, and increasing the responsibilities of the ratings agencies' boards. Many of these features mirror the expanded corporate governance requirements for auditors imposed by the Sarbanes-Oxley Act

But at the same time, Dodd-Frank allows some of the "independent" board members to be users of ratings. This ignores the fact that investors in rated securities have their own incentives to avoid downgrades. Instead of reducing conflicts of interests, Dodd-Frank may very well simply be substituting one conflict of interest for another.

One of the Dodd-Frank rating agency reforms has already had tremendous negative impact on our capital markets—so much so that the SEC has effectively voided the provision. This Section, 939G, repeals SEC rule 436(g), which had exempted NRSROs from being deemed part of a security's registration statement for the purposes of securities fraud. Rule 436(g) had protected NRSROs from liability under Section 11 of the 1933 Securities Act. This protection actually increased the flow and quality of information received by investors by encouraging the use of ratings in offering statements. Dodd-Frank's repeal of Rule 436(g) effectively shut down the new offerings market for asset-backed securities and corporate debt. It was only the issuance of a "no-action" letter from the SEC to Ford Motor Credit Company that allowed this market to function. The Dodd-Frank Act, attempts to remedy regulatory failures with the increased use of private litigation. Section 933 expands the potential legal liability of rating agencies in three ways. First, it established a private right of action under Section 18 of the 1934 Securities Act for any material misstatements contained in reports to the SEC. Second, it established liability for errors in factual assumptions used in a ratings methodology. Third, and last, there is established legal liability under Section 21E of the 1934 Securities Act for misstatements in any forward-looking statements made by the rating agencies. Of course, one defence to these charges would be to adopt a reasonable-man approach to ratings methodology and predictions. Basing ratings on consensus, or even government forecasts of key economic variables, would likely provide some shield to liability. Providing a consensus viewpoint could, however, greatly reduce the informational value provided by ratings. Increased liability could easily make rating agencies risk-averse and less likely to offer unconventional points of view. Agencies could also be subject to suit by investors "harmed" by the downgrade of assets which they hold. Other provisions of Dodd-Frank are also likely to reduce the utility of rating agencies, with damaging impacts on our capital markets. One of this provision is embedded in Section 939B that eliminates the rating agencies exemption from Regulation FD, which covers the "fair disclosure" of information. Regulation FD prohibits senior executives of public companies who regularly communicate with the public from making selective disclosure of non-public informational material to select persons. Prior to Dodd-Frank, the rating agencies were exempted, with the understanding that the ratings process would be better informed if the rating agencies had occasional access to non-public information. Section 939B has the potential to reduce the flow of information between public companies and the rating agencies, with the result that ratings become less informed. In Section 939A of Dodd-Frank, the law takes a serious step toward reducing the regulatory reliance on the rating agencies. It requires all federal agencies to review their existing regulations and to provide alternative standards of credit risk. Although the federal bank regulators have, requested public comments as to possible alternatives, these same regulators have moved slowly on Section 939A and have shown a general resistance to abandoning their reliance on the rating agencies.

While Section 939A has the potential to address some of the central flaws discussed, it also leaves considerable discretion to the very same regulators who instituted those flaws. For Section 939A to have real impact, however, it may well take the continued involvement of Congress.

Overall, the Act is a mixed bag when it comes to the credit rating agencies. Some provisions have a real potential for reform, but their success is also contingent on the same regulatory process that created the problems.

CONCLUSION

Credit rating agencies are an important part of the globalized financial system and thus influence the global economy. Following the global financial and economic crisis, and the role of CRAs therein, the legal regime applicable to credit ratings and CRAs have come under scrutiny both at the national and international levels. Credit ratings plays a fundamental role for the judgement of risk-sensitive activities, and to reduce information asymmetries and principal-agent problems in financial markets. Because ratings balance accuracy with stability, no viable alternative exists. Private CRAs are best-suited to providing independent assessments of the creditworthiness of an issuing entity. However, natural barriers of entry in the rating industry and widespread conflicts of interest have led to a deterioration in the quality of ratings. Overreliance on credit ratings, lack of due diligence and competition have been made out as major factors having contributed to the developments that put CRAs in a critical place in the crisis. Both in the United States and in the EU legislative activities were subjected to reviews. Since 2009, led by the United States, the legislative effort went in the same direction. The European Union, in fact, until the adoption of the first regulation, then improved over the following years, maintained a neutral behaviour against rating agencies, so called self-regulation approach. This change direction has led to the adoption of three new regulations in four years, going from a regime of self-regulation to over-regulation, in response to the sovereign debt crisis of 2011, arriving even to address Civil Liability to rating agencies if responsible for the damages caused to the state or the investors. Over-regulation as a populist response in times of crisis is of course anticipated. It is among the most powerful tools in a politician's array of choices. The aim of this paper is to describe the radical change of the European choice regarding the CRAs. All of this driven by the International bodies' guideline and giving a glance to the USA regulation framework and the relative updates.

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