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Credit Rating Agencies in the EU:
Gatekeepers in a New Regulatory Paradigm

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**CREDIT RATING AGENCIES IN THE EU:
GATEKEEPERS IN A NEW REGULATORY PARADIGM**

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To my little Riccardo

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Abstract

Accurate and reliable credit ratings promote market efficiency by allowing issuers to signal their creditworthiness to lenders, thus helping lenders allocate capital to creditworthy borrowers. This paper looks at the role of credit rating agencies (CRAs) and outlines some problems regarding their incorporation into the regulatory structure. Comments on the emergence of a new regulatory paradigm in the financial services are following the prospect of the implementation of the New Basel Capital Accord (Basel II): its standardised approach hinges on ratings and involves the delegation of duties to CRAs as “informational intermediaries”. Such a regulatory reliance on CRAs is not as developed in the EU as it is in the US. In light of the recent flurry of regulatory initiatives, the purpose of this study is to discuss the attitude that EU regulators should adopt in approaching CRAs accountability. Taking into account the competitive dimension of the credit rating market, it is not easy to find the appropriate degree of regulatory oversight that should be applied to CRAs: between a complete market-based approach and the implementation of a much more pervasive regulatory regime, based on registration and barriers to entry. The proposed approach would contribute to enhancing the accountability (and credibility) of CRAs by reinforcing - behind *appropriate* regulation - existing market pressures and enforcement policies.

Introduction

Credit rating agencies (CRAs) can play an important role to the efficiency of modern capital markets. Since the 20th century, they have emerged as informational intermediaries specialising in the assessment of the creditworthiness of companies.

The performance of CRAs, like that of financial analysts and of other informational intermediaries,¹ has been the object of criticism during the past few years. The collapse of Enron and the Parmalat case – and the CRAs failure to lower their credit ratings quickly enough – has once again brought the role of CRAs (among others) under the spotlight.²

Despite its criticised role, the credit rating process has continued to evolve. The need for reliable ratings has increased in recent years for two reasons: *first*, financial markets have become increasingly international with complex products that reduce transparency for the investor. *Second*, due to the new capital requirements for banks under the Basle II standards³ – and, consequently, under the Capital Requirement Directive (the “CRD”)⁴ transposing those provisions – a borrower’s rating has become an increasingly important factor influencing borrowing costs.

In the wake of the Enron debacle, and in view of the new regulatory paradigm in which seems to be an “outsourcing” to CRAs of certain functions traditionally performed by regulation⁵, CRAs’ regulatory reform efforts have been accelerated. In parallel to the US Securities and Exchange Commission (SEC) initiatives, the International Organisation of Securities Commissions (IOSCO) and the European Commission sought to examine further the role and effectiveness of CRAs.⁶ These studies founded recent policy initiatives.⁷

In light of the recent flood of regulatory initiatives, the purpose of this study is to discuss the attitude that EU regulators should adopt in approaching CRAs accountability. The proposed approach would contribute to enhancing the accountability of CRAs by reinforcing existing reputational pressures. First, in *chapter I*, we offer some background information on the role of CRAs in the functioning of securities

¹ JC Coffee “Understanding Enron. It’s about the Gatekeepers, Stupid” Columbia Law School WP n.207 30th July 2002; M Onado “I risparmiatori e la Cirio: ovvero, pelati alla meta” (2003) 3 Mercato, concorrenza e regole, 526 ff.

² IOSCO *Annual Conference* (14-17 October 2003 Seoul Korea).

³ Basel Committee on Banking Supervision “International Convergence of capital Measurement and Capital Standards” June 2004.

⁴ Directive of the European Parliament and of the Council Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (Consolidated Banking Directive) and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (Capital Adequacy Directive), 18 October 2005. The CRD was approved under the UK Presidency when Finance Ministers reached agreement, at a single reading, on the European Parliament’s legislative resolution on the CRD on 11 October 2005. The Directive is expected to be formally adopted by the Council in spring 2006, following the translation of the Directive into all EU languages. Member States must transpose, and firms should apply, the Directive from the start of 2007. During 2007, credit institutions and investment firms as defined by the MiFID, can choose between the current “Basel I approach” and the simple or medium sophistication approaches of the new framework. The most sophisticated approaches will be available from 2008. From this date, all affected EU firms will apply Basel II through the CRD.

⁵ 30th Annual Meeting of the IOSCO, Panel of Rating Agencies, Colombo, Sri Lanka, 6 April 2005, Statement of J. Rutherford Jr, Chairman and CEO Moody’s Corporation.

⁶ IOSCO, TECHNICAL COMMITTEE, *Report of the Activities of Credit Rating Agencies*, 2003 [hereinafter *IOSCO Report*]; SEC, *Report on the Role and Function of Credit Rating Agencies in the operation of the Securities Markets*, 2003, [hereinafter *SEC Report*]; U.S., SENATE, STAFF OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, 2002 [hereinafter *Watchdogs Report*]; U.S., SENATE, COMMITTEE ON GOVERNMENTAL AFFAIRS, *Rating the Raters: Enron and the Credit Rating Agencies*, 107th Congress, 2nd Session, 2002 [hereinafter *Rating the Raters*].

⁷ IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies*, December 2004 [hereinafter *IOSCO Code*]; SEC, “Definition of Nationally Recognized Statistical Organization”, 17 CFR Part 240, Federal Register, No. 70 Vol. 78, April 25, 2005 [hereinafter *NRSRO Definition*]; CESR, *CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies*, March 2005 [hereinafter *CESR’s Technical Advice*].

markets; in *chapter II*, we deal with the regulatory incorporation of CRAs in Basel II and in the Capital Requirement Directive (CRD) implementing it; in *chapter III*, we examine how a market-based approach could deal with the work of CRAs; then, in *chapter IV*, we review the potential failures that pervade the credit rating market; *finally*, in the conclusions, we identify the areas in which the regulators, especially European, stand.

I. CRAs, informational intermediaries and the functioning of securities markets

Given the vast amount of information available to investors today – some of it valuable, some of it not - CRAs “can play a useful role in helping investors and others sift through [...] information and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer’s debt and debt-like securities”.⁸ Typically, a credit rating aims to measure the creditworthiness of issuers.⁹ They also offer ratings of individual debt instruments that indicate the probability of default or delayed payments with respect to that particular security.

Rating decisions are typically based not only on public information,¹⁰ but also on private/confidential information (including credit agreements, acquisition agreements, private placement memoranda and management’s business projections and forecasts and have face-to-face meetings with issuers’ officers and directors) which companies agree to share with CRAs.¹¹ Generally, in fact, CRAs have privileged access to information about issuers or borrowers and devote considerable resources to analysing that information. In addition, their rating decisions incorporate qualitative judgments regarding the plans and effectiveness of borrowers’ management.¹²

Some market participants, in particular banks and large institutional investors, enjoy similar informational advantages. However, only a limited number of investors have available sufficient credit departments to make detailed credit analyses with respect to their investments; many other investors rely on credit ratings when assessing the credit quality of borrowers and debt issues.¹³

The increase in the number of issuers and the advent of new and complex financial products - such as asset-backed securities and credit derivatives - in the last few years, have amplified significantly the importance of CRAs’ opinions to investors and other market participants, and the influence of these opinions on the securities markets. In fact, as borrowers have turned more and more towards the capital markets rather than the bank lending markets, and as banks increasingly arrange financial structures funded through the capital market rather than their own balance sheet, the perception of investors becomes more significant in assessing the marketability and pricing of debt.¹⁴

By redressing some of the information asymmetry, CRAs are useful not only to investors, but also to issuers (or at least for those issuers who receive a favourable rating).¹⁵ Together with other “informational

⁸ IOSCO Code (n 8).

⁹ More technically, it has been defined by Moody’s, as an “opinion of the future ability, legal obligation, and willingness of a bond issuer or other obligor to make full and timely payments on principal and interest due to investors.” (Moody’s Investor Service. 2003. *Ratings Definitions*. New York, NY: Moody’s).

¹⁰ Public information consists of financial, accounting and other information about the issuer, as well as current and prospective macro economical and market factors that may affect the issuer’s or the debt.

¹¹ Except for unsolicited ratings, which focus only on public information.

¹² On the importance of subjective evaluations of raters compared with statistical models, see A Resti and C Omacini “Che cosa determina i rating creditizi delle aziende europee?” *Banche e Banchieri* 28 No 3 197-216.

¹³ M Micu EM Remolona and PD Wooldridge “The price impact of rating announcements: evidence from the credit default swap market” (2004) BIS Quarterly Review, 2.

¹⁴ SK Henderson “Henderson on Derivatives” (Lexis Nexis Butterworths 2003), 10.

¹⁵ Communication from the Commission on Credit Rating Agencies, Brussels, 23.12.2005, available at: http://europa.eu.int/comm/internal_market/securities/agencies/index_en.htm

intermediaries” - such as public or private credit registries or financial analysts¹⁶ - in reviewing information from a variety of sources, they contribute to reduce adverse selection problems resulting from information asymmetries between investors and issuers: if left unrated, in fact, the debt of issuers with good credit quality may be undervalued, thereby undermining the viability of markets.¹⁷ Furthermore, while investors typically insist on being compensated for risk and issuers pay for this risk through higher interest rates, CRA ratings help investors better understand risks and uncertainties, thus reducing financing costs for issuers.¹⁸ The fact that issuers are willing to pay for ratings, and that investors are willing to accept lower interest rates for rated securities, might indicate that CRAs do a good job providing valuable information.¹⁹

Some doubt of the informational value of credit rating.²⁰ However, there are many reasons - based also on empirical evidence -²¹ to suppose CRAs nevertheless produce valuable information.²² Indeed, a rating *is* information.²³ In other words, a downgrade does not just convey information: the fact that a downgrade has occurred *is* information.²⁴

II. Basle II and a new regulatory paradigm: regulatory policy implications.

Regulatory failures - both under-regulation and over-regulation - in the financial markets, has increasingly led to the recognition of the significance of the data and services provided by informational intermediaries. Regulators and supervisory authorities increasingly rely on such professional bodies in filling informational gaps and, in particular, increasingly incorporate the views of CRAs into supervisory procedures.²⁵

This regulatory incorporation of the work of CRAs – that traditionally has been particularly visible in the US while less common in Europe –²⁶ can be found in the new international capital requirements framework agreed by the Basel Committee on Banking Supervision (“Basel II”) in 2004²⁷. Compared to the

¹⁶ E Cervone “EU Conduct of Business Rules and the Liberalisation Ethos. The Challenging Case of Investment Research” (2005) 16(2) *European Business Law Review*, 421-456 .

¹⁷ The general adverse selection problem was introduced by GA Akerlof, “The Market for ‘Lemons’: Qualitative Uncertainty and the Market Mechanism”, (1970) 84(3) *Q. J. Econ.* 488-500.

¹⁸ *IOSCO Report* (n 6).

¹⁹ CA Hill “Regulating the rating agencies” (2004) 82(43) *Washington U L Quat*, 65.

²⁰ Hill (n 19) p 72; N Linciano “L’impatto sui prezzi azionari delle revisioni dei giudizi delle agenzie di rating. Evidenza per il caso italiano” (2004) 2 *Banca Impresa e Società*.

²¹ P Jorion Z Liu and C Shi “Informational Effects of Regulation FD: Evidence from Rating Agencies” WP Graduate School of Management University of California Irvine May 2004 Forthcoming in *Journal of Financial Economics*.

²² LH Ederington JB Yawitz and BE Roberts “The Information Content of Bond Ratings” *The Journal of Financial Research* X, 211-26 (1987); AW Butler and KJ Rodgers “Relationship Rating: How Do Bond Rating Agencies Process Information?” WP June 2003; Basel Committee on Banking Supervision “Credit Ratings and Complementary Sources of Credit Quality Information” WP No 3 August 2000 (http://www.bis.org/publ/bcbs_wp3.pdf).

²³ A study of D Kliger and O Sarig (“The Information Value of Bond ratings” (2000) *J. of Fin.*, pp 2879-2902) which focuses on the refinement of Moody’s rating system in 1982, shows that investors do react to rating changes if they are unexpected, in the same way as they react to new information.

²⁴ Hill (n 19), 69. Typically, the market reacts more strongly to ratings downgrades than to rating upgrades. The overreaction to downgrades could reflect the fact that a downgrade convey additional information: it signals that the rated issuer has either decided not to or proved unable to avoid the downgrade (European Central Bank, “Market Dynamics Associated with Credit Ratings. A Literature Review”, *Occasional Paper Series No. 16 (2004)*).

²⁵ CRAs have been incorporated in the Italian regulatory system since Law n.130/99 on securitisation. In particular, Consob Regulation n. 12175 established the professionalism requirements of CRAs’ analysts in securitisation operations. Before that, they were only mentioned in relation to the characteristics of financial instruments in fund management. Consob recently proposed to insert a discipline of CRAs, in relation with the valuation of the creditworthiness of listed companies, within art. 114 Consolidated Law on Financial Intermediation (T.U.F.).

²⁶ Basel Committee on Banking Supervision (n 22). This paper surveys regulatory incorporation of CRAs in a broader range of jurisdictions.

²⁷ Basel II is a more flexible and complex system, combining precise rules, guiding principles, considerable discretion for supervisory authorities and market discipline. See Bagheri (n 34) 345.

basic *a priori* risk weightings of Basel I, based solely on the debt belonging to a certain category, the Basel II Agreement seeks to implement capital requirements based on the bank counterpart's actual credit quality. Basel II, in its "standardised approach to credit risk", provides that banks will have the option of determining credit quality based on credit ratings provided by external rating entities, including CRAs. While the number of internal ratings profoundly exceeds the numbers of external ratings, and the standardised approach is considered as a transition to an internal ratings-based approach (IRB), its simplified framework will ensure that it will be applied to a wide array of financial institutions.²⁸

The implementation of Basel II is underway in the EU (nine EU Member States are represented on the Basel Committee – Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden and the United Kingdom), under the Capital Requirement Directive ("CRD").²⁹ The Directive, which introduces a new capital requirements framework for banks and investment firms, would then extend the use of ratings in European legislation. A recognition mechanism is outlined in the Directive: the CRD provides that, in order to determine risk weights (and consequential capital requirements), banks and investment firms may use external credit ratings, provided the External Credit Assessment Institutions ("ECAIs") – mainly CRAs - issuing them were designated as "eligible" by national authorities ("direct recognition"). If an ECAI has been recognized as eligible by the competent authorities of a member State, the competent authorities of other member States *may* recognize the ECAI as eligible without carrying their own evaluation process ("indirect recognition"): a nearly "European passport" for ECAIs in the EU is thus created.^{30 31}

This process and regulatory dependence on informational intermediaries presents a paradox as it amounts to the privatisation of the regulation.³² Credit ratings facilitate the creation and enforcement of rights with low transaction costs for bank regulators,³³ that in using ratings to set capital standards, will become credit rating "consumers", while in the past the real consumer of credit ratings was the individual investor. New and difficult questions of public policy, as well as a more complex question on whether informational intermediaries should be subject to more extensive regulatory supervision, arise.³⁴ One wonders, in fact, whether centralized regulators will be as good monitors of CRAs as decentralized market forces in the past.

As also Professor Howell Jackson highlighted,³⁵ the regulatory incorporation of credit ratings in bank capital requirements puts greater pressure on the system. The enhanced importance of credit ratings³⁶ will

²⁸ According to P Van Roy ("Credit Ratings and the Standardised Approach to Credit Risk in Basel II", European Central Bank Working Paper Series, No. 517/August 2005, p 5, 7, 10), evidence indicates that the standardised approach will be adopted by 30% of European banks, mostly active in the retail, securities and cooperative sectors; outside the G-10, the standardised approach will also be the one preferred by most banks moving to Basel II given their accounting and information weaknesses.

²⁹ Directive of the European Parliament and of the Council (n 4).

³⁰ Building on the CRD, the Committee of European Banking Supervisors ("CEBS") is working to promote convergence of the recognition processes of ECAIs across the EU by defining a common understanding on the criteria necessary to implement the recognition requirements laid down in the CRD. In January 2006 the Committee issued the "Guidelines on the recognition of External Credit Assessment Institutions", available at <http://c-eps.org>. While formal processes cannot begin before finalisation and transposition of the CRD, many national supervisors intend to be in a position to accept informal applications in the near future. Those supervisors have started this process based on these guidelines from the beginning of February 2006. In view of the approaching deadline for implementation, Bank of Italy is starting the process of recognition of ECAIs based on these Guidelines (see Banca d'Italia "External Credit Assessment Institutions (ECAI): iniziativa in vista del riconoscimento", Roma, Feb 2006).

³¹ The analysis on whether it would be appropriate to assimilate CRAs to ECAIs will be discussed further.

³² F Partnoy "The Paradox of Credit Ratings", in *Ratings, Rating Agencies and the Global Financial System* (Richard M. Levich et al. eds., 2002); RS Kroszner "Can the Financial Markets Privately Regulate Risk?" *J Money, Credit and Banking* Vol 31 No 3 (Aug 1999 Part 2).

³³ European Central Bank (n 24).

³⁴ M Bagheri "Informational Intermediaries and the Emergence of the New Financial Regulation Paradigm" *Comp Law* 2003 24(11) 344-345.

³⁵ HE Jackson "The Role of Credit Rating Agencies in the Establishment of Capital Standards for Financial Institutions in a Global Economy" in E Ferran and CAE Goodhart (eds) *Regulating financial services and markets in the 21 st century*, Oxford, Portland, Or., Hart Pub (2001).

indeed increase the pressure to get better ratings. Thus, while this change could increase the need for governmental oversight of CRAs, there should be a likely “capture” of the regulator: if banking regulators in a particular country are reluctant to force local banks to raise capital to the standards set by the Basel Committee, one way to subvert compliance is to accept higher-than-appropriate ratings from local CRAs.³⁷ Since to encourage national regulators to raise capital requirements for local banks was one of the goals of the Basel Capital Accords, one can appreciate the potential problem of this new use of CRAs. In other words, as Basel II allows national regulators latitude for setting capital requirements for commercial credits, the goal of maintaining uniform capital standards across national boundaries may be jeopardized.

Partnoy points out that, by employing ratings as a tool of regulation, regulators have fundamentally changed the nature of the product CRAs sell, as issuers pay rating fees to purchase, not only credibility with the investor community, but also a “license” from regulators.³⁸ According to the “regulatory license” view, ratings are nowadays valuable, not because they are accurate and credible, but because they are the key to reducing costs associated with regulation.

The foregoing concerns raise the possibility that Basel II, the CRD and other regulatory incorporations of CRAs at the national level - changing the structure of the market for credit ratings - could undermine the quality of credit ratings thereby generating a form of credit rating inflation.

III. A market-based approach

A refusal of regulatory solutions – indicated, quite obviously, by most of the market participants’ responses³⁹ to the SEC Concept Release, the IOSCO Code and the CESR Consultation Paper⁴⁰ – is supported by many reasons.

First, strict regulation may prevent CRAs from quickly adjusting to market innovations, which would have, in turn, the unintended consequence of reducing the quality and availability of information. According to CESR,⁴¹ one area in which flexibility is required is that of notice of change to rating methodologies and rating criteria⁴². *On the one hand*, advance notice of change is of great relevance to issuers who need to know in advance the methodologies and criteria that will be applied to their own rating.⁴³ *On the other hand*, however, it is also essential for the protection of investors and the integrity of the rating process that CRAs may freely alter their views of the criteria to obtain a particular rating and the best methodology for assessing creditworthiness. Only then, they can adapt to fast changing circumstances and product innovation. Therefore, the basic principle of pre-disclosure should not apply in circumstances where it is impossible or impractical to inform issuers and the public before the changes are implemented.⁴⁴

³⁶ Under Basel II, an issuer’s credit rating will affect not only its access to capital markets, as it currently does, but also the borrower’s cost of commercial loans from regulated entities (since the cost of higher capital charges will likely be passed on to borrowers at least in part).

³⁷ J Ammer and F Parker “How consistent are credit ratings? A Geographic and sectoral Analysis of default Risk” Board of Governors of the Federal Reserve System International Finance Discussion Paper No.668, regarding the home bias effect.

³⁸ F Partnoy (n 32).

³⁹ Comments received by the SEC on the Concept Release are available at <http://www.sec.gov/rules/concept/s71203.shtml>; Comments received by CESR are available on <http://www.cesr-eu.org/>

⁴⁰ CESR “Technical advice to the European Commission on possible measures concerning credit rating agencies” Consultation Paper, Nov 2004.

⁴¹ CESR Consultation Paper (n 40) p 27.

⁴² IOSCO, Code Fundamentals Provision 3.10

⁴³ This is especially important because securities may need to be sold quickly to take advantage of short market windows, or because a change in methodology or criteria may alter ratings or delay transactions, thus impacting on the issuer’s ability to fund itself.

⁴⁴ BMA Public Comment on Code of Conduct Fundamentals for Credit Rating Agencies November 2004.

Second, CRAs' own reputation plays an important role in their discipline. It is true that the role of reputation could be seriously undermined: when firms pay for their own ratings, CRAs might be tempted to give inflated ratings.⁴⁵ In fact, firms could threaten to take their business elsewhere if they do not get the desired rating, or they can offer to pay more in exchange for a higher rating. Potential conflicts of interest faced by CRAs have increased in recent years, particularly given the expansion of large CRAs into ancillary services, and the continued rise in importance of CRAs in the U.S. securities markets. *However*, CRAs have good reasons to avoid conflicts of interest and to protect the accuracy of their ratings, because they need to preserve their reputation. Recent studies,⁴⁶ also at the empirical level,⁴⁷ show that CRAs' concern for their reputation will override their susceptibility to influences of this type. In fact, the market reacts to a CRA losing or gaining credibility in the eyes of the investor community:⁴⁸ if market thinks a firm can get a high rating just by paying for it, ratings will not be valued and firms, then, will not pay much to get ratings. Consequently, CRAs will become far less profitable and may even fail.⁴⁹

Several mechanisms facilitate the development of reputational sanctions: *first*, in requiring CRAs to demonstrate how they comply with the Code Fundamentals, Provision 4.1 provides the market with an additional tool to assess a CRA's credibility; *in addition*, CRAs maintain detailed statistics as to the performance of rated issues and the accuracy of ratings can be measured *ex post*, so that deficiencies in performance may become known; *furthermore*, unsolicited ratings may be rendered by CRAs on issuers that have already been rated by a biased agency.

Above all, other compelling counter-balancing market-driven "checks" exist, such as other informational intermediaries, investors' and issuers' own risk management functions, and other available market information.⁵⁰

Indeed other informational intermediaries exist, such as credit registries and financial analysts. *On the one hand*, public or private credit registries – even if they do not engage in additional analysis of current and prospective factors that may also affect credit risk in the future – help investors overcome some information asymmetries by providing them with information about an issuer's credit history. *On the other hand*, financial analysts, like CRAs, play an important role in the relationship between investors and issuers and can contribute to the market's overall understanding of the vast volume of raw data that investors will wish to digest in order to make informed decisions.⁵¹ In addition – and in contrast with CRAs – financial analysts opine on whether a particular debt security should be bought, sold or held.⁵²

Investors' own risk management functions are another information source. *On the one hand*, most of the large buy-side firms (such as mutual funds, pension funds, and insurance companies), substantial users of information from CRAs, typically conduct their own credit analysis for risk management purposes. Buy-side firms use credit ratings as one of several important inputs to their own internal credit assessments and investment analyses. *On the other hand*, like buy-side firms, many sell-side firms (*e.g.*, broker-dealers that make recommendations and sell securities to their clients) conduct their own credit analysis for risk management and trading purposes. However, many broker-dealers also maintain rating advisory groups.

⁴⁵ For an extreme chastising view, see F Partnoy ["The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies", 7 *Wash. U. L. Q.* 619, 658 (1999)] according to which "the reputational capital view of credit rating agencies is not supported by history or economic analysis".

⁴⁶ Hill (n 19), 50.

⁴⁷ DM Covitz and P Harrison "*Testing Conflicts of Interest at Bond Rating Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate*", 2003, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2003-68. This empirical study shows that the conflicts of interest of CRAs do not influence their actions significantly.

⁴⁸ Partnoy (n 32).

⁴⁹ For a general discussion of rating agencies' concern with their reputations, SL Schwarcz "*Private Ordering of Public Markets: The Rating Agency Paradox*" 2002 U. ILL. L. REV. 14; SL Schwarcz "The Role of Rating Agencies in Global Market Regulation" in *The challenges facing financial regulation* forthcoming LLP Professional Publishing, London) (abstract available at http://papers.ssrn.com/paper.taf?ABSTRACT_ID=237668).

⁵⁰ G Imperatori "Dibattito sul "nodo" rating, questione ancora aperta" article on *Il Sole* 24 Ore 23/09/2004.

⁵¹ Cervone (n 16).

⁵² IOSCO "Report on the Activities of Credit Rating Agencies" Sept 2003, 3.

These groups generally assist underwriting clients in selecting appropriate CRAs for their offerings, and help guide those clients through the rating process.

In addition, market-based indicators (e.g. credit default swap spreads, stock prices and bond spreads) could be used as counter-balancing market-driven “checks”. Some observers argued indeed that, most of the times, such indicators are much better than CRAs in evaluating the “true” credit worthiness of the debtors and that too often “markets” anticipate rating announcements.⁵³ In particular, according to Partnoy, credit spreads already incorporate the information contained in credit ratings.⁵⁴

Finally, there is no evidence of systematic failure. It is true that, for example, all the three global agencies had rated Enron an investment-grade company until four days before it filed for bankruptcy and that they had rated WorldCom similarly until a few months before it collapsed. However, Enron (and others) involved fraud that CRAs cannot be expected to detect: CRAs analyze debt issuers' financial positions to try to predict for investors an entity's ability to reimburse its debt; they are not in place to audit auditors and cannot eliminate fraud, since their mandate is to provide transparency to the financial market.⁵⁵ Although individual “mistakes” will occur, and ratings may lack of the short-term accuracy relative to market-based indicators,⁵⁶ studies on rating performance show a strong correlation between ratings and the likelihood of default.⁵⁷

According to the above, detailed regulation of CRAs seems inappropriate. While it is important that investors understand that ratings are fallible, and that a favourable rating is not a guarantee, excessive government involvement in the rating process would give investors false comfort that could ultimately undermine rather than reinforce investor confidence: in case of overregulation, the markets become less vigilant about the agencies' reputation, leading to moral hazard behaviours.

IV. Competitive dimension: where the regulators stand

In principle, because of its value, the reputation built by CRAs – together with the other market-based mechanisms – provides an economic incentive to behave diligently, even in the absence of regulation. In practice, however, two market failures are noteworthy in this regard: agency problems and imperfect competition.

Potential conflicts of interest arise as CRAs receive most of their compensation from the issuers they rate. Other conflicts of interest arise in connection with provision of ancillary services (risk management, consulting services, etc.): issuers may be forced to purchase these services to keep the agency on side. However, as far as worries over agency problems are concerned, CRAs should not be willing to risk damaging their reputation to retain a particular firm as client (see chapter III); furthermore, agency problems would be mitigated by competition in the CRAs market.

⁵³ A Di Cesare “Do market-based indicators anticipate rating agencies?” (WP Bank of Italy 2004).

⁵⁴ Partnoy (n 32). According to Partnoy, because credit spreads are determined by the market as a whole, not by any individual entity, a credit spread-based system would not create “regulatory licenses” for any approved agency. His point of view is even that credit spreads are more accurate than credit ratings and reflect at minimum the information contained in credit ratings. According to this, and to the extent the Basel II decides to employ categorical risk weights, the author suggests that it would be better if those weights depended on credit spreads than on credit ratings.

⁵⁵ See SEC Report (n 6), p 26. The same according to Basle II: rating agencies are implicitly exempted from verifying the truthfulness of financial information.

⁵⁶ European Central Bank (n 24).

⁵⁷ See the last rating-performance study issued by S&P quoted by L Mancinelli (“L’assegnazione di rating da parte delle agenzie: significato, implicazioni e principali aspetti critici” in *Bancaria* n.3/2005, p 5). The mentioned study shows that the default percentage associated with class AA is 1,45%, with class BB is 24,57% and with class CCC is 61,58%. According to the SEC (*Report to the Senate Committee on Governmental Affairs*, in http://www.senate.gov/~gov_affairs, p 99), statistically “credit rating agencies generally get it right”.

The competitive dimension is, thus, the critical cog. The highly concentrated market structure of the rating industry⁵⁸ may hinder the smooth functioning of the reputation mechanism: even if a CRA suffers loss of reputation, new entrants may not be able to displace it because of the barriers to entry. It is well known that the industry counts only three global players: Moody's Investors Service, Inc; Standard and Poor's, a division of The McGraw-Hill Companies, Inc (S&P); and Fitch, Inc, all based in the US. Moody's, S&P, Fitch and, from 2003, Dominion Bond Rating Service Limited (DBRS), a small Canadian firm, are currently the only NRSROs (National Recognised Statistical Rating Organisations")⁵⁹. Moody's and S&P play as leaders (US Dept of Justice labelled it "partner monopoly"), Fitch and DBRS as distance followers.⁶⁰

Consequently, global CRAs enjoy a considerable market power, so that they may extract rent from issuers, which pay for the rating.⁶¹ According to G Ferri,⁶² although raising a distributive problem, rent extraction does not *per se* imply the industry efficiency; however, their market power might lead the agencies to indulge in underinvestment, which would indeed cause inefficiency: in fact, if global CRAs invest less than the socially optimal amount in collecting and processing information on rated issuers, the quality of the ratings they issue is sub-optimal.

The oligopolistic nature of the credit rating market could be not only the consequence of anti-competitive practices by the CRAs. Significant natural barrier to competition exist. The need, by the bond issuers, for a ratings recognition that comes from a long-established firm, effectively bars newcomers from the global arena. Today it is possible that only large firms with a (preferably longstanding) reputation for credibility and expertise can feasibly provide such a service. Furthermore, other natural barriers to entry exist, given the highly qualified analysts and the high-tech methodologies required.⁶³ With age, expertise and size conferring significant advantages, it is not easy for new CRAs to be established or gain a significant presence in the market: a new entrant into the CRAs industry is hard pressed to compete on price or low standards.

To be sure, globalization and specialisation offer cause for optimism in this regard. *On the one hand*, once market participants in developed markets become more familiar with undeveloped markets, and the markets become more integrated with one another, the monopoly may be eroded. *On the other hand*, becoming a small niche agency should not be hard. Notwithstanding the economies and advantages of general-purpose agencies, the smaller, more specialized agencies may be able to establish themselves more readily and fundamentally change the nature of the market. Indeed, there is a growing number of smaller, regional (especially in Europe, China and India) and/or specialized agencies. It is thus welcomed to give special treatment to CRAs entering new markets.

Potential competition serves as a constraint, as does the spectre of increased regulatory scrutiny.⁶⁴ However, as regards the competitive dimension of CRAs activity, the impact of regulation is not clear, especially in the EU, where CRAs regulation is not as developed as in the US. Regulation in this contest would not necessarily increase competition: it may act as a measure to reduce or removing entry barriers to

⁵⁸ Recent M&A of CRAs increased concentration: in 2000, Fitch bought Itarating DCR and Thomson BankWatch. See LJ White ["The Credit Rating Industry: An Industrial Organization Analysis", paper presented at the Conference on "The Role of Credit Reporting Systems in the International Economy", The World Bank, Washington DC, 1-2 March (2001)] for a critical assessment of the degree of competition and contestability in the credit rating industry.

⁵⁹ Since 1975, the SEC (*SEC Regulation 15c3-1*) has relied on credit ratings from "market-recognised credible" CRAs in order to distinguish between grades of creditworthiness in various regulations under the federal securities laws. The SEC, through the no-action letter process, recognizes these agencies as NRSROs.

⁶⁰ L Norden and M Weber "Informational Efficiency of Credit Default Swap and Stock Markets: The Impact of Credit Rating Announcements" CEPR Discussion Papers 4250 (2004): reviews for downgrade by S&P and Moody's have largest impact on credit default swaps and shares. See also Ferri & Sasaki ["More ain't always better: Efficient entry in the credit rating industry", WP Ente Einaudi July 2005].

⁶¹ In spite of the little data available, White (n 58) documents the high returns of the rating agencies.

⁶² G Ferri "More Analysts, Better Ratings: Do Rating Agencies Invest Enough in Less Developed Countries?" WP (August 2003).

⁶³ SEC Report (n 7).

⁶⁴ Hill (n 19).

the rating industry - thus permitting new entrants to displace the biased or incompetent agency – but also to increase them.

Firstly, regulation could lower entry barriers. Improving publicly available information through compulsory disclosure by issuers could facilitate the entry of new CRAs. Indeed, new entrants might see one option to enter the CRAs market by building their reputation based on unsolicited ratings⁶⁵, which are based only on publicly available information. Thus, barriers to entry may be mitigated if issuer disclosure provides sufficient and clear information to the public so that new entrant can draw accurate opinions.⁶⁶

Indeed, one of the most fundamental impediments to the accurate appraisal of issuers by CRAs is the inability of CRAs to access a continuous flow of accurate and reliable information from issuers. We should question whether the level of public disclosure by issuers is adequate and whether there should be additional improvements to the extent and quality of disclosure by issuers (including: the need for additional detail regarding an issuer's short-term credit facilities, conditional elements of important financial contracts, special purpose entities, material future liabilities and, particularly in light of the Enron experience, better disclosure of the existence and nature of "ratings triggers" in contracts material to an issuer⁶⁷).

In the EU, the recently approved Transparency Directive⁶⁸ completes a package of Financial Services Action Plan (FSAP) measures adopted over the last two years (the IAS Regulation, the Market Abuse Directive,⁶⁹ the Prospectus Directive⁷⁰) to establish a common financial disclosure regime across the EU for issuers of listed securities. By contrast, unlisted companies suffer by insufficient public disclosure.

Secondly, strict regulation could enhance entry barriers. In fact, a regulation that strictly impede selective access to information to subscribers of the CRAs service, that pay for a detailed analysis and information, may adversely affect competition in the CRAs market. Indeed, it is important to note that subscription services form the primary source of revenue for smaller CRAs and new entrants, meaning that restrictions on selective access to information may adversely affect smaller CRAs that rely on these subscriptions.⁷¹

However, particular concern regards this special access of subscribers to CRAs information. As also mentioned in a SEC report,⁷² while the larger CRAs generally make ratings available simultaneously to subscribers and non-subscribers, subscribers have access to substantial additional information, such as

⁶⁵ Unsolicited ratings are ratings neither requested by nor paid for by the issuer.

⁶⁶ CESR "Technical advice to the European Commission on possible measures concerning credit rating agencies" Consultation Paper (2004), 16.

⁶⁷ The widespread use of "ratings triggers" in financial contracts recently has received considerable attention because of certain high-profile bankruptcies, such as Enron and Pacific Gas and Electric Company (PG&E). In the case of Enron, the use of credit ratings as "triggers" in trading and other financial agreements gave counterparties the right to demand cash collateral, and lenders the right to demand repayment of outstanding loans, once Enron's credit rating declined to certain levels. As a result, the existence of ratings triggers contributed to Enron's financial difficulties. Similarly, the impact of credit rating downgrades on PG&E's financial agreements limited its ability to borrow funds to repay its short-term debt obligations. In cases such as these, contractual ratings triggers can seriously escalate liquidity problems at firms faced with a deteriorating financial outlook. Thus, transparency is an important feature to mitigate some of the negative aspects of rating triggers (European Central Bank (n 24)). According to the European Commission's Regulation on Prospectuses n° 809/2004, rating triggers that can be understood as covered by the notion of "covenants" would be disclosed in the prospectus to be published when securities are offered to the public or admitted to trading.

⁶⁸ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L 390/38 (Transparency Directive).

⁶⁹ Directive 2003/6/EC of the European Parliament and of the Council of 28 Jan 2003 on insider dealing and market manipulation (Market Abuse Directive).

⁷⁰ Directive 2003/71/EC of the European Parliament and of the Council 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 [2004] OJ L 345 (Prospectus Directive).

⁷¹ CESR (n 66), 32.

⁷² SEC "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets" (2003), 8.

detailed rating reports and other analyses, as well as direct access to rating agency analysts for elaborative conversations. Thus, questions have been raised as to whether this preferential subscriber access to important information about issuers and CRAs creates an unfair information asymmetry in the marketplace and increases – through additional, informal, communications – the risk of improper disclosure of confidential information provided by the issuer.

At a first sight, the above-mentioned concerns seem wholly appropriate, as the public ratings decision may be based on information that the public is not aware of. Indeed, in the US, SEC Regulation Fair Disclosure (FD)⁷³ prohibits US public companies from making selective, non-public disclosures to favored investment professionals (such as financial analysts), but it has a number of exclusions, one of which still allows disclosure of non-public information to CRAs (not just NRSROs), because they “have a mission of public disclosure”. Similarly in the EU, pursuant to the Market Abuse Directive (“MAD”).⁷⁴ However, also the concerns of small CRAs seem appropriate: they are not compensated for the loss of value, arising from selective access to subscribers, by other means, such as overcharging issuers, because they are not afforded a monopoly.⁷⁵ Detailed disclosure requirements could then constitute an undue entry barrier for start-ups and would impose excessive additional burdens on smaller firms, so that they must be kept to a minimum to avoid competitive distortions.

Thirdly, the CRAs’ “recognition process” established by Basel II could have a significant impact upon the trade-off between competition in CRAs market and high-quality ratings.⁷⁶ According to Basel II, “national supervisors are responsible for determining whether an external credit assessment institution (ECAI) may be recognised on a limited basis”.

In Europe, in case of external ratings, use is made of the products of what are known as recognised ratings agencies, which are not currently subject to an authorisation process. As outlined above - in view of the importance of external ratings in connection with the calculation of capital requirements - the CRD intends to keep under review appropriate future authorisation and supervisory process for rating agencies. It requires - direct or indirect – recognition of ECAIs as “eligible” by national authorities, which shall disclose an explanation of their recognition process and a list of eligible ECAIs. In particular, the CRD sets out a number of requirements which ECAIs should meet before the competent authority grant them recognition. For example, their ratings must be objectively and independently assigned and reviewed on an ongoing basis; their rating procedures must be sufficiently transparent; the competent authorities should assess whether individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments and accessible at equivalent terms to all interested parties.

Is it appropriate or not for CRAs to be registered in the EU? If so, how and under what type of regime, bearing in mind the need to avoid enhancing barriers to entry? The rationale of the “recognition process” apparently is that the process can to some extent substitute for the lack of vigorous competition in the CRAs industry. However, there is the possibility that a similar “certification” could become the analogue to the US one, where the barriers to entering the NRSRO market are prohibitive. As the open debate mandated on the SEC by the Sarbanes-Oxley Act reveals, there is growing consensus in the US that NSROs barriers to entry should be (partially) removed.^{77 78}

⁷³ Selective Disclosure and Insider Trading, Release No. 34-43154 (August 15, 2000), 65 FR 51716.

⁷⁴ According to the MAD, as a rule, an issuer must disclose inside information as soon as possible. However, the Directive allows an issuer to disclose inside information privately to a third party, such as a CRA, where the recipient is under a duty of confidentiality, regardless of whether such duty is based on laws, regulations, articles of association or on contract (Article 6(3)). This is true also for communications with subscribers.

⁷⁵ According to Hill (n 19), Moody's' profit margins have been as high as fifty percent. S&P is a division of McGraw-Hill, and profit figures are not released separately. However, an analyst estimated that S&P has margins of a lower, but still enviable, thirty percent. Fitch, like Standard & Poor's, is wholly owned by a private company, so that its profits are therefore similarly impossible to determine. Hill, though, supposes that it is less profitable than the other two: “...its market share is far smaller, its market position is apparently far weaker, and its fees have been estimated by some market participants to be appreciably less than those of Moody's and Standard & Poor's”.

⁷⁶ CESR (n 66), 18.

⁷⁷ White (n 61) demands full liberalisation dropping NSROs.

The European Parliament,⁷⁹ in view of the implementation of Basel II, called upon the Commission to undertake all necessary steps to assess the establishment of a competent “European Registration Scheme” for the registration of CRAs in Europe; by contrast, CESR’s point of view was to abandon the idea of a “registration scheme”, preferring to follow the IOSCO approach (according to which it is important that the requirements of the Code Fundamentals be not implemented by being turned into rigid regulatory requirements⁸⁰). In line with the CESR’s Technical advice⁸¹, the European Commission has adopted a Communication setting out its approach to CRAs, which indicates that – despite the EU Parliament’s initial preference for pervasive regulation - the EU would adopt the IOSCO approach, leaving the implementation of the code to market pressures.⁸²

Consensus in Europe seems to build on removing barriers to entry in view of rating agencies’ fallacies. As CESR notes in its Technical Advice, “a significant number of respondents expressed the desire for regulators to carefully avoid increasing barriers to entry, stating that any statutory/unduly prescriptive regulation could increase barriers”. However, along with CESR, “the small CRAs had an opposite view, as they think that a regulatory mechanism with a clear set of criteria that CRAs would follow could have a positive effect on competition”. This last view is supported by Ferri & Sasaki,⁸³ according to which the debate overlooks how the removal of barriers might affect quality: as their model shows, in the case of competition of both prices and quality, barriers to entry might be desirable.

On the one hand, the EU should limit market access exclusively to highly reliable CRAs, thus avoiding the potential distortions that would stem from the creation of rating agencies with lesser standing, with a tendency to issue better ratings as a means of penetrating the market and for this reason less trustworthy. *On the other hand*, while we need certain identification of the CRAs deemed eligible by the supervisory authorities,⁸⁴ the implementation of a recognition regime may be perceived as creating barriers to entry in the market for external credit assessments.

The kinds of recognition criteria to be used are the critical cog in this framework. “Credibility” (the market recognition of credibility and reliability of ECAI’s individual credit assessments), is one of the “Eligibility Criteria” set forth by Basle II and is also mentioned by the CRD. Since market acceptance is the evidence of the credibility of the assessment, this criterion should bring us back to the regulatory power of the market. However, according to the CRD, “credibility” shall be assessed by competent authorities according to factors such as “the market share of the ECAI” or “the revenues generated by the ECAI”: this may be explained by the fact that regulation of ECAIs aims at ensuring safe risk management by banks or investment firms of their capital reserves and therefore focuses more on aspects of CRA market experience, credibility, resources; less on competition. In fact, while these criteria may be satisfied only by the three big CRAs and a few others, might not be suited for smaller CRAs and new entrants. Thus, other indicators of market credibility may be considered. For example, according to the CEBS, evidence that a large number

⁷⁸ The SEC – asked to clarify the procedures it uses for recognising CRAs and to review periodically the CRAs it recognises (as acknowledged in a survey on CRAs released in Nov 2002 by the US Association of Financial Professionals) - is trying to find the appropriate degree of regulatory oversight that should be applied to CRAs.

⁷⁹ European Parliament, “Resolution on the role and methods of CRAs”, February 2004.

⁸⁰ IOSCO’s Principles regarding the Activities of Credit Rating Agencies, Introduction paragraph, available at www.iosco.org/IOSCOPD151. These Principles (published in October 2003) set high-level objectives for CRAs, securities regulators, issuers and other market participants to improve investor protection and market fairness, efficiency and transparency and to reduce systemic risk. In response to comments on these principles, IOSCO developed the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. Moody’s and Standard and Poor’s (Dec. 2005), Fitch Ratings and Dominion Bond Rating Service Limited (March 2006) have expressed their desire to join this voluntary framework.

⁸¹ CESR (n 7); see also R Sabbatini ““Graziate” le agenzie di rating”, article on *Il Sole-24 Ore*, 31 March 2005.

⁸² Communication (n 15); Speech, Internal Market Commissioner Charles McCreevy, “Rating Agencies let off the hook - for now”, *EurActiv*, April 11, 2005 online at: <http://www.euractiv.com/Article?tcaturi=tcm:29-137622-16&type=News>.

⁸³ Ferri & Sasaki (n 60).

⁸⁴ See ABI “Comments of the Italian Banking Association on the CEBS proposals on recognition of the ratings of External Credit Assessment Institutions for purposes of calculating capital requirements against securitizations for banks using the Standardised Approach and the Ratings Based Approach”, September 2005.

of institutions plan to use an ECAI's credit assessments for regulatory capital purposes may be viewed as an indication of market credibility for the purpose of ECAI recognition.

To be sure, CRAs may choose not to become ECAIs under the CRD and therefore the CRD may not cover the entire population of CRAs. It only covers those CRAs that want to be recognized for external ratings and it is not obvious that all CRAs will have an interest in becoming recognized in this respect. As CESR analysed in its Technical Advice,⁸⁵ we should question whether it should be appropriate to consider as CRAs only those entities that meet the Commission's criteria for eligible ECAIs. *On the one hand*, this approach would have an impact on the entry barriers to the ratings industry: if CESR considered as CRAs only those entities that have gained recognition, this would affect the competitive dimension. *On the other hand*, creating another regulatory system for CRAs in the EU, in addition to the CRD requirements for ECAIs, could lead to duplication of the regulatory burden for CRAs. The objectives of the ECAI recognition system cannot be seen separately from the aims of other legislation and supervisory standards applicable to CRAs since the CRD affirms the meaningful function of CRAs.⁸⁶

It is extremely important the way in which the CRD will be implemented. A flexible, market oriented, approach - but not only based on market share or market coverage - that motivates CRAs (included new entrants) to protect the reputation on which the investor relies, will better deal with the CRAs own business models and with different legal and market circumstances. Indeed, it would be hard to regulate an analytical process involving subjective opinions: this would have a detrimental impact on the quality and diversity of ratings information.

Should a registration regime be introduced, it should simply require the CRA to attest it is following the IOSCO Code provisions. Furthermore, the IOSCO Code - which focuses more on objectives than methods or standards - should not be transposed into a detailed set of regulations: the Code, if correctly implemented, could avoid that a "certification regime" will further enhance entry barriers to the credit rating market. There will be good chance that competition between different certified players will be strong if a few rules will be established into the codes: *first*, to require CRAs to disclose and explain the key elements underlying the rating and to provide an explanation of the assumptions on which the rating is based and the factors to which the rating of an issuer is most susceptible to change; *second*, to require CRAs to certify and periodically re-certify compliance with the Code Fundamentals; *third*, by establishing clear procedures where users of ratings can raise and address concerns about non-adherence by CRAs to the Code Fundamentals; *fourth*, by providing for a transparent process where issuers and their advisers can appeal rating decisions in appropriate circumstances.⁸⁷

In particular, coming back to the third and fourth points mentioned above, we need sanctions that are not only reputational. If there is corruption in the rating process, national authorities should be able to apply appropriate sanctions, both to individuals and to CRAs. In the US, CRAs are protected by law from the risks of "gatekeeper" liability faced by other financial intermediaries: the mere fact that CRAs have been sued is not evidence that the CRAs' expected litigation costs are high, because CRAs always win (the suits typically are dismissed or settled on favourable terms to the CRAs).⁸⁸ Furthermore, the nation's courts have ruled that the work of these agencies is *opinion* and therefore protected by the First Amendment ("Congress shall make no law [...] abridging the freedom of speech or of the press [...]"). However, even if ratings are categorized as "opinions", the legal consequence of this categorisation should not be to allow them to freely express their opinions and to obtain protection from civil litigation, as someone stated.⁸⁹

Finally, we should consider the international context. In recognition of the fact that the largest CRAs (based mainly in the US) and many rated issuers compete in global markets, any form of regulation and/or registration at EU level of CRAs, or within EU member states, should involve close contact with the US

⁸⁵ CESR (n 7).

⁸⁶ Communication (n 15).

⁸⁷ The Bond Market Association (BMA) "Response to IOSCO Proposed Code of Conduct for Credit Rating Agencies" (2004).

⁸⁸ Partnoy (n 32).

⁸⁹ IOSCO (n 5).

SEC, in order to maximise the opportunity for the convergence of principles between the European and US regulatory approaches. For example, ratings-based capital requirements would be most effective if regulators cooperate closely, so that the certification criteria are harmonised across borders.⁹⁰ Absent such coordination, international banks would have an incentive to a “rating shopping”: in other words, “to book a rated asset in the country that certifies the rating agency with the most benign view of the underlying credit risk”.⁹¹

Furthermore, with regard to issuers’ transparency and disclosure criteria, a set of standard information should be globally defined, in order to allow possible cross-country comparison. Indeed, CRAs are able to produce ratings that are more accurate if issuers share relevant non-public information with the agency: if this practice is permitted in one country and forbidden in another country, the performance of that CRA’s ratings could differ between the two countries.

Indirect recognition is an important feature of the framework and it is suggested that the default presumption should be toward indirect recognition rather than it being an option. Indeed, not to have such a presumption, could potentially create a block to competition in those markets where ECAI access is restricted.⁹² However, it is regrettable to note that the CRD does not provide the possibility for EU Member States to recognise an ECAI based on recognition by a regulator in a non-EU country (indirect recognition for Third Country EU equivalent regulatory regimes). Indeed, while smaller banks are likely to use the Standardised Approach and therefore ECAI ratings in relation to domestic or European exposures, for larger banks the use of ECAI ratings is likely to be in relation to non-EU overseas operations (such as those significant exposures in Brazil, South Africa, and parts of Asia). As such, larger banks in particular, seek then to improve the relations with IOSCO and, in particular, with the US authorities to ensure future consistency with international standards.⁹³

Conclusions

The credit rating market in Europe is much less developed than in the US. Relatively a small number of issuers are rated, given their traditional bank-oriented, as opposed to market-based, finance. The impact of Basle II (and of the Capital Requirement Directive implementing it) might change the *status quo* in the EU, marking the emergence of a new regulatory paradigm in the area of financial services. The most noticeable feature of the new paradigm is delegation of regulatory duties to informational intermediaries such as CRAs, creating a new and more complex regulatory structure.

The main problems this regulatory change could address are those resulting from market concentration in the CRAs industry: the price of ratings may not be as low, and the quality of ratings may not be as high, as would be the case if the industry were more competitive. However, the impact of regulation in the competitive dimension is not clear: regulatory intervention is likely to increase barriers to entry, and thus to negatively affect competition, but it might also be beneficial to quality.

In particular, the paper discusses the recognition regime, as established by the CRD, since it could have a significant impact upon the trade-off between competition in CRAs market and high-quality ratings. While we need certain identification of the CRAs deemed eligible by the supervisory authorities, the implementation of a recognition regime may be perceived as creating barriers to entry in the market for external credit assessments.

⁹⁰ R Sabbatini “Fitch: ci controlli il mercato” article on *Il Sole 24Ore* (13th Jan 2005).

⁹¹ Basel Committee on Banking Supervision (n 22).

⁹² BBA, ISDA and LIBA Response to the CEBS Consultation on the recognition of External Credit Assessment Institutions, 30 Sept 2005.

⁹³ BBA, ISDA and LIBA (n 92).

Should a registration regime for CRAs – other than ECAIs (External Credit Assessment Institutions) - be introduced, the recognition process must not impose any disproportionate additional entrance barrier to the rating market for start-ups. It should simply require transparent, simple, stringent but attainable criteria for recognition or approval of rating agencies. Flexibility should be required for CRAs - especially new entrants, smaller, specialised and/or foreign CRAs - to be able to adjust the provisions to their own business models, in addition to complying with different legal and market circumstances.

Intrusive regulation may give investors the impression of a sort of guarantee given by regulators of the quality of ratings, and investors could be entitled to expect perfect reliability and quality of ratings to the extent that all the aspects of CRAs activity are regulated in detail. Instead, investors should bear in mind that ratings are *opinions* translated by ratings. Credit ratings, while are valuable for investors because they permit to grab economies of scale and to reduce information asymmetries between issuers and investors, are only one source available to market participants about credit quality. Ratings do not substitute for the need to monitor carefully other information sources, so that market participants and bank regulators should also depend also on other complementary sources of credit quality information.

Rather, it is regrettable that the CRD does not provide indirect recognition for Third Country EU equivalent regulatory regimes. Above all, it is regrettable that, while major reforms are currently under way in the EU to accelerate the integration process, the CRD does not provide a “perfect mutual recognition” of rating agencies within the EU, so that a real “European Passport” for rating agencies is not yet created.

Actually, the discussion should not only be about regulation, but also about the ways in which, given the (existing and forthcoming) regulation, supervision should be carried out. Beside appropriate regulatory mechanisms, enforcement policies are vital for the credibility of the CRA market. If there is corruption in the rating process, national authorities should be able to apply appropriate sanctions, both to individuals and to CRAs. Even if ratings are categorized as *opinions*, the legal consequence of this categorisation should not be to allow them to freely express their opinions and to obtain protection from civil litigation, as it is currently in the US.