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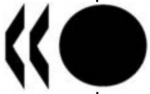

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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CREDIT RATING AGENCIES: COMPETITION RELATED ISSUES

-- Note by Mr. Karel Lannoo --

This note was prepared for the Secretariat by Mr. Karel Lannoo from the Centre for European Policy Studies (CEPS) to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 16-17 June 2010.

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**WHAT REFORMS FOR THE CREDIT RATING INDUSTRY?
A EUROPEAN PERSPECTIVE**

-- Note by Mr. Karel Lannoo --

1. The credit rating industry finds itself in the eye of the storm. Singled out early on in the financial crisis as being in need of more regulation, policy-makers seem not to have taken comfort from the regulation that has been adopted in the meantime, and want to go further. Faced with a rapid decline in ratings in the context of the sovereign debt crisis, Commissioner Barnier raised the possibility of creating a new Europe-based ratings agency, which could specialise in sovereign debt.

2. The debate on the role of ratings agents considerably pre-dates this crisis. Already in the 1997 South-East Asia crisis, the late reaction of ratings agents to the public finance situation of these countries was strongly criticised. The same applied for the dot.com bubble in 2001 with regards to the ratings of corporates. Many reports were written on their role, but it took the EU until 2008 before a consensus emerged that the sector was in need of statutory legislation. In the meantime, the US had adopted the Credit Rating Agency Reform Act in 2006. At global level, in 2003 the IOSCO adopted a 'Statement of Principles' on the role of credit rating agencies, without much success, apparently.

3. The regulatory problem rating agents pose is multiple, and cannot be solved easily. Some of these are specific to the profession, and the current market structure, others are of a more generic nature. Some are related to basic principles of conduct regulation in the financial services sector, others are part of horizontal market regulation. The financial crisis also raised the importance of their role in financial stability, which involves macro-prudential authorities.

4. This paper starts with an overview of the credit ratings industry today. The second part analyses the use of credit ratings and demonstrates that the authorities have created a captive or artificial market for CRAs. The third part reviews the new EU CRA regulation, and its possible impact. The fourth part compares proposals for regulatory reform.

1. The credit ratings industry today

5. As is well known, the credit ratings industry is a global business, controlled by only a few players, two of which are of US parentage. Moody's and Standard & Poor's alone control more than $4/5^{th}$ of the market. With Fitch, the three leading players control over 94% of the global market (European Commission 2008).

- Moody's investor services was incorporated in 1914 as a bond rating and investment analysis company. Today, the listed company Moody's Corporation is the parent company of Moody's Investors Service, which provides credit ratings and research covering debt instruments and securities, and Moody's Analytics, which encompasses non-ratings businesses, including risk management software for financial institutions, quantitative credit analysis tools, economic research and data services, data and analytical tools for the structured finance market, and training and other professional services. Moody's employs about 4,000 persons.

- Standard & Poor's was incorporated in 1941 further to the merger of two firms active in credit risk analysis. Both firms originated in similar circumstances as Moody's, in the context of the huge industrial expansion of the US in the second half of the 19th and early 20th centuries. S&P was taken over by Mc Graw Hill in 1966, the listed media concern, and forms the most important part of the group in revenues, and even more in profits (about 73%), although seriously declining since 2007. S&P financial services, which includes the ratings service, employs about 7,500 persons.

- Fitch Ratings is much the smaller 'European' player in the sector, headquartered in New York and London, and part of the Fitch Group. In addition to Fitch Ratings, the Fitch Group also includes Fitch Solutions, a distribution channel for Fitch Ratings products and Algorithmics, a leading provider of enterprise risk management solutions. The Fitch Group is a majority-owned subsidiary (60%) of Fimalac S.A. since 1997, headquartered in Paris, France, and listed on Euronext, but with a very low free float. Fitch grew through acquisitions of several smaller ratings agents, including IBCA and Duff & Phelps. Fitch employs 2,266 persons.

6. The three groups suffered serious declines in revenues since 2007, which was most evident in the case of Fitch. Fitch revenues declined by 26% since 2007, and its net income by 70%. This may confirm the finding discussed below that more competition does not necessarily improve the quality, but that newcomers, in this case Fitch, attempt to attract market share with a short-term strategy. Table 1 also indicates that the market share of the three firms is fairly constant over the period 2006-2009.

Table 1. Turnover and net income of the 'big three' ratings businesses (2006-2009)

in $		**2006**	**2007**	**2008**	**2009**	**Δ 07-09**
Moody's	turnover	2037.1	2259	1775.4	1797.2	-20.4
	net income	753.9	701	461.6	407.1	-41.9
S&P	turnover	2750	3046.2	2653.3	2610	-14.3
	net income	n.a.	440.16	327.8	307.4	-30.2
Fitch	turnover	655.6	827.4	731.2	613.5	-25.9
	net income	n.a.	120.2	44	35.8	-70.2

Sources: Moody's K-10 filings, Fimalac's filings, Hoover's, S&P's website, Fitch Ratings' website, McGraw-Hill's K-10 filings.

7. That the credit rating business is essentially of American parentage should be no surprise, as they are an intrinsic part of the market-driven system pioneered by the US. Unlike the bank-driven model, which is common in Europe, a market-driven system relies upon a multi-layered system to make it work (Black, 2001). Reputational intermediaries, such as investment banks, institutional investors, law firms and ratings agents, and self-regulatory organisations, such as professional federations and standard setters, play an important role to make the system, in between issuers and supervisors, work.

8. As there has not been much of a capital market in Europe until recently, banks have essentially performed the credit risk analysis, and continue to do so. Possibly as a result of the reputational strength of the US capital market model, the credit risk analysis function of European banks declined. In addition, European authorities created a captive market for an essentially US-based industry.

2. A European captive market for CRAs

9. Two forms of 'regulation' have given the CRAs a captive market in the EU: Basel II, implemented as the capital requirements directive (CRD) in Europe, and the liquidity providing operations by the ECB. Both explicitly use the rating structure of the CRAs to determine risk weighting for capital requirement purposes, the threshold and haircut respectively for liquidity providing operations. Neither is the case in the US, as Basel II has not been implemented, and the discount window of the Fed is not based upon ratings.

10. The Basel II proposals were finalised in November 2005 after lengthy discussions, among other things on its pro-cyclical impact and because of the use of private sector rating agents. In its standardised approach, to be used by less sophisticated banks, it bases risk weightings on ratings agents' assessments. The capital requirements increase with the decline of the rating, from 0% for up to AA-rated government bonds, or a minimum of 20% for banks and corporates to 150% for CCC or below. However, in the EU's CRD, the risk weighting is 0% across the board for all EEA based sovereigns funded in domestic currency. A zero-risk weighting means that a bank has to set no capital aside for these assets.

11. As no EU regulation existed at the time of adoption of the CRD, the Committee of European Banking Supervisors (CEBS) adopted "Guidelines on the recognition of External Credit Assessment Institutions" in January 2006. These guidelines set criteria for 'mapping' external credit assessments to the CRD risk weights. The acceptance of a rating agent for the purposes of the CRD is thus with the national supervisory authorities. For comparison, the Japanese FSA has specified the five rating firms for the purposes of calculating risk weights for the standardised approach, the three firms mentioned above and two smaller Japanese firms.

12. The use of ratings agents is possibly even more prevalent for the marketable assets to be used as collateral in the ECB's liquidity providing operations. The credit assessment for eligible collateral is based predominantly on a public rating, issued by an eligible external credit assessment institution (ECAI). In the ECB's definition, an ECAI is an institution whose credit assessments may be used by credit institutions for determining the risk weight of exposures according to the CRD.[1] The minimum credit quality threshold is defined in terms of a 'single A' credit assessment,[2] which was temporarily relaxed during the financial crisis. If multiple and possibly conflicting ECAI assessments are available for the same issuer/debtor or guarantor, the first-best rule (i.e. the best available ECAI credit assessment) is applied.[3]

13. The liquidity categories for marketable assets are subdivided into five categories, based on issuer classification and asset type, with a growing level of valuation haircut, depending on the residual maturity.[4] An important group in the context of the financial crisis, category V, are the asset-backed securities (ABS), or securitisation instruments. The extent to which banks used ABS collateral in liquidity operations rose dramatically after mid 2007, from 4% in 2004 to 18% in 2007 and 28% in 2008 (Fitch, 2010, p. 7). Within ABS, residential mortgage-backed securities form the most important element, exceeding 50%. These securitisation instruments, and in particular the residential mortgage-backed securities (RMBS) segment, were an extremely important market for CRAs. Moody's, for example, assigned the AAA rating to

1 ECB (2006) General documentation on Eurosystem monetary policy instruments and procedures, p. 43

2 "Single A" means a minimum long-term rating of "A-" by Fitch or Standard & Poor's, or "A3" by Moody's, ECB (2006), p. 41.

3 ECB (2008) General documentation on Eurosystem monetary policy instruments and procedures, p. 42

4 See latest change to risk control measures in Eurosystem credit operations, European Central Bank, Press notices, 4 September 2008.

42,625 RMBS from 2000 to 2007 (9,029 mortgage-backed securities in 2006 alone) as in a ‘factory’, and later had to downgrade the assets. In 2007, 89% of those considered investment grade were reduced to junk status.[5]

3. The EU rating agencies regulation

14. As the financial crisis erupted, these and other stories rapidly led to a policy consensus that ratings agents should be regulated at EU level. The proposal for a regulation was made in November 2008, and adopted in April 2009; a minimum period in EU decision-making.[6] The regulation was also the first new EU legislative measure as a result of the financial crisis. It is at the same time one of the first financial services measures to be issued as a regulation, meaning it is directly applicable, rather than a directive, which has to be implemented.

15. The EU was not starting from scratch. Back in 2004, further to an own initiative report of the European Parliament (Katifioris report) the EU Commission asked the Committee of European Securities Regulators (CESR) for technical advice regarding market practice and competitive problems in the CRAs. In a Communication published in December 2005, it decided that no legislation was needed for three reasons: 1) three EU directives cover ratings agents indirectly, the market abuse, CRD and MiFID directives: 2) the 2003 IOSCO Code; 3) self-regulation by the sector, following the IOSCO Code.[7]

16. In 2006, the CESR, in a report for the EU Commission, concluded that the ratings agents largely complied with the IOSCO Code.[8] But concerns remained regarding the oligopoly in the sector, the treatment of confidential information, the role of ancillary services and unsolicited ratings. In a follow-up report published in May 2008, focusing especially on structured finance, the CESR strongly recommended following the international market-driven route by improving the IOSCO Code. Tighter regulation would not have prevented the problems emerging from the US subprime, according to the CESR.

17. The EU regulation:

- requires CRAs to be registered and subjects them to ongoing supervision;
- defines the business of the issuing of credit ratings;
- sets tight governance (board structure), operational (employee independence and rotation, compensation) and conduct of business (conflicts of interest) rules for CRAs;
- requires CRAs to disclose their methodologies, models and rating assumptions. CESR will establish a central repository with the historical performance data.

18. The regulation came into force 20 days after its publication in the official journal, this is 7 December 2009. But guidance has to be provided by CESR before the regulation can take effect, by 7 June 2010 regarding registration, supervision, the endorsement regime, and supervisory reporting; by 7 September regarding enforcement practices, rating methodologies and certification. CESR has to report annually on the application.

5 Phil Angelides, Chairman of the US Congress Inquiry Commission on the causes of the financial crisis, quoted in Bloomberg, June 2, 2010.

6 Regulation 1060/2009 of 16 September 2009, OJ 17.11.2009.

7 Communication from the Commission on Credit Rating Agencies (2006/C 59/02), OJ C 59/2 of 11.03.2006.

8 CESR’s Report to the European Commission on the compliance of Credit Rating Agencies with the IOSCO Code, CERS, 06-545

19. The novelty in the regulation is the central role of CESR in providing advice regarding the requirement for registration by a CRA in an EU member state, and in informing all the other member states. The home and host member states to the CRA are required to establish a college and are required to co-operate in the examination of the application and in day-to-day supervision. Host member states are not only those where a CRA has a branch, they are also those where the use of credit ratings is widespread or has a significant impact. In these circumstances, the host country authority may at any time request to become a member of the College (Art. 29.3). Host countries can also act against an agency deemed to be in breach of its obligations (Art.25). CESR has the authority to mediate between the competent authorities (Art. 31), which pre-empts its transformation in a securities market *authority* under the proposals discussed at present.

20. As the industry is essentially of US parentage, a focal point in the discussions was the third country regime. The regulation states that CRAs established in a third country may apply for certification, provided that they are registered and subject to supervision in their home country, and that the Commission has adopted an equivalence decision. However, credit ratings registered in a third country can only be used if they are not of systemic importance to the EU's financial stability (Art 5.1), meaning that all large CRAs need a full EU registration. In addition, credit ratings produced outside the EU need to be endorsed by the CRA registered in the EU (Art. 4.3). It has been argued that this regime will unnecessarily fragment global capital markets. Foreign companies will be less inclined to raise capital in the EU, as they need a local endorsement of their rating, which banks need for regulatory purposes. EU financial institutions will invest less abroad, as the ratings on third country investments may be seen to be of insufficient quality. The regime could also be qualified as anti-competitive, as smaller CRA without an EU presence, such as the two of the largest CRAs in Asia, may stop rating EU sovereigns and issuers. Establishing a local presence in the EU could be too costly, and the client base for these ratings would as a result diminish, since they can no longer be used by European banks (St. Charles, 2010).

21. The amendments the EU Commission published on June 2nd 2010 modify the regulation to the imminent creation of the European Securities Market Authority (ESMA), and to further centralise the supervision of CRAs.[9] The ESMA would become the sole supervisor, doing away with the complex system described above. It does however not give a greater role to the European Systemic Risk Board (ESRB) in supervising CRAs macro work. The regulation also proposes a similar disclosure requirement as under the SEC's Rule 17g-5, which affects issuers of structured finance instruments. This change was welcomed by the markets as it would make both regimes convergent.

4. The regulatory debate

22. The EU's regulation does not alter the fundamental problem that CRAs pose from a public policy perspective: 1) the oligopolistic nature of the industry; 2) the inherent conflict of interest through the issuer-pays principle; 3) the public good of the private rating. The EU approach seems to be a second best solution. A more fundamental review is needed of the business model of the CRAs, and which other industry sectors could provide a model.

23. On the structure of the industry, by introducing a license and setting tight regulation, the EU increases the barriers to entry, rather than taking the oligopolistic nature as one of the fundamental reasons for the abuses. In addition, as statutory supervision of the industry may increase moral hazard, it gives a regulatory 'blessing' and will further reduce the incentives for proper risk assessments in the banking sector. It creates the illusion that the industry will live to the new rules, and that this will adequately supervised.

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9 Proposal for a regulation of the European Parliament and of the Council on amending regulation (EC) No 1060/2009 on credit rating agencies, COM(2010) 289/3.

24. For Marco Pagano (2009), the preferred policy is more drastic: 1) ratings should be paid by investors, and 2) investors and ratings agencies should be given free and complete access to all information about the portfolios underlying structured debt securities. The investor-pays principle was the rule in the US until the 70s, but because of increasingly complex securities in need of large resources, and the fear of declining revenues resulting from the dissemination of private ratings through new information technologies, the issuer-pays principle was introduced. Moving back to the investor-pays principle may also require further regulation, however, to prohibit the sale of ancillary services by CRA's to issuers. The EU regulation goes into the direction of requiring more disclosure, but it is questionable whether investors will read this. On the contrary, given that a supervisory *fiat* has been established, investors may even be less inclined to read all the information, as was demonstrated during the financial crisis.

25. Making investors pay would bring the ratings agents closer to the profession of analysts and investment advisors, which is regulated under the EU's Market in Financial Instruments Directive (2004/39). MiFID requires investment advisors to be licensed, to act in the best interests of their clients, and to identify, disclose and avoid conflicts of interest. MiFID also states that firewalls need to exist between analysts and sales departments in banks.

26. Ponce (2009) discusses an interesting alternative to the issuer-pays model: the platform-pays model. He demonstrates empirically that the transition from the investor-pays to the issuer-pays model had a negative impact on the quality of the ratings. Under the issuer-pays model, a ratings agency may choose a quality standard below the socially efficient level. In this case, a ratings agency does not internalise the costs that investors suffer from investing in low-quality securities. A ratings agent may give ratings to low-quality securities in order to increase its revenues. To avoid this, he proposes the 'platform-pays' model; a form of clearing house for ratings, complemented by prudential oversight of ratings' quality to control for bribery. The platform assigns the agent (based on performance and experience) and the issuer pays up front. This would at the same time overcome the oligopoly problem.

27. Other research proves that more competition would not necessarily improve standards, however. New entrants do not necessarily improve the quality of ratings – on the contrary. They attract business by friendly and inflated ratings. As competition reduces future rents, it increases the risk of the short-term gains by cheating. In an analysis of the corporate bond markets, Becker and Milbourn (2009) find a significant positive correlation between the degree of competition and the level of the credit ratings (see also figure 2 in annexe). Concretely, they find a positive correlation between Fitch's presence and ratings levels, without exception.

28. Considering that incentives and reputational mechanisms are key, Larry Harris (2010) proposes an entirely different approach. He takes his inspiration from the bonus debate in the banking sector, and proposes to defer a part of the payment based upon results. Given that credit ratings are about the future, the performance of the securities rated would be the indicator for the fees rating agents can charge. An important part of the fees would be put into a fund, against which the ratings agencies could borrow to finance their operations. Disclosure of these deferred contingent compensation schemes would be required, so that investors can decide for themselves which schemes provide adequate incentives.

29. Another possibility to create the right incentives is moving to a partnership structure in the rating business, as is common in the audit sector. The audit sector has several similarities with rating agencies in the type of work, the importance of reputation and global presence, the network economies and the oligopolistic structure, and the conflicts of interest. The audit sector is regulated by an EU directive (2006/43/EC) which brought the sector under statutory supervision. It sets tight rules on governance and quality control, and limits the degree of non-audit services audit firms can perform for an audit client. This directive also has an important third country equivalence regime. Interesting to note in this context is that at least two audit firms have recently indicated to be interested in starting a rating business.

5. Conclusion

30. Considering the policy alternatives outlined above, the EU and the US should probably have considered the specificities of the sector a bit more carefully before embarking upon legislation. The legislation that was adopted does not address the fundamental problems of the industry and gives rise to side effects; the most important of which is the supervisory seal. Given the depth of the financial crisis, and the central role played by ratings agents, certainly in the EU, a more profound change would be useful, towards the 'platform-pays' model or a long-term incentive structure, as discussed above.

31. The EU regulation, as adopted, consolidates the regulatory role of CRAs in the EU system, but the price is high. It fragments global capital markets, as it introduces a heavy equivalence process, and requires a local presence of CRAs and endorsement of systemically important ratings. It is at the same time protectionist.

32. Under the new set-up, CESR, and its successor ESMA are given a central role in the supervision of CRAs, but the question is whether they will be able to cope. The supervisor needs to check compliance with the basic requirements to decide on a licence, and needs control adherence to the governance, operational, methodological and disclosure requirements imposed upon CRAs, which is quite a workload, especially considering that no supervision was in place until a few months ago. Given the present debate on the financial stability implications of the CRAs' role, and the need for technical expertise, the European Systemic Risk Board could have been involved, but this seems not to be on the cards for the moment.

33. On the other hand, the advantage of having a regulatory framework is that the EU's competition directorate can start scrutinising the sector from its perspective. To our knowledge, the European competition policy dimension of the CRA sector has not been investigated so far, as no commonly agreed definitions and tools were available at EU level, and since the sector is essentially of US parentage. The requirement for an EU registration for the large CRAs allows to check their compliance with EU Treaty rules on concerted practices and abuse of dominant position, which may raise some feathers.

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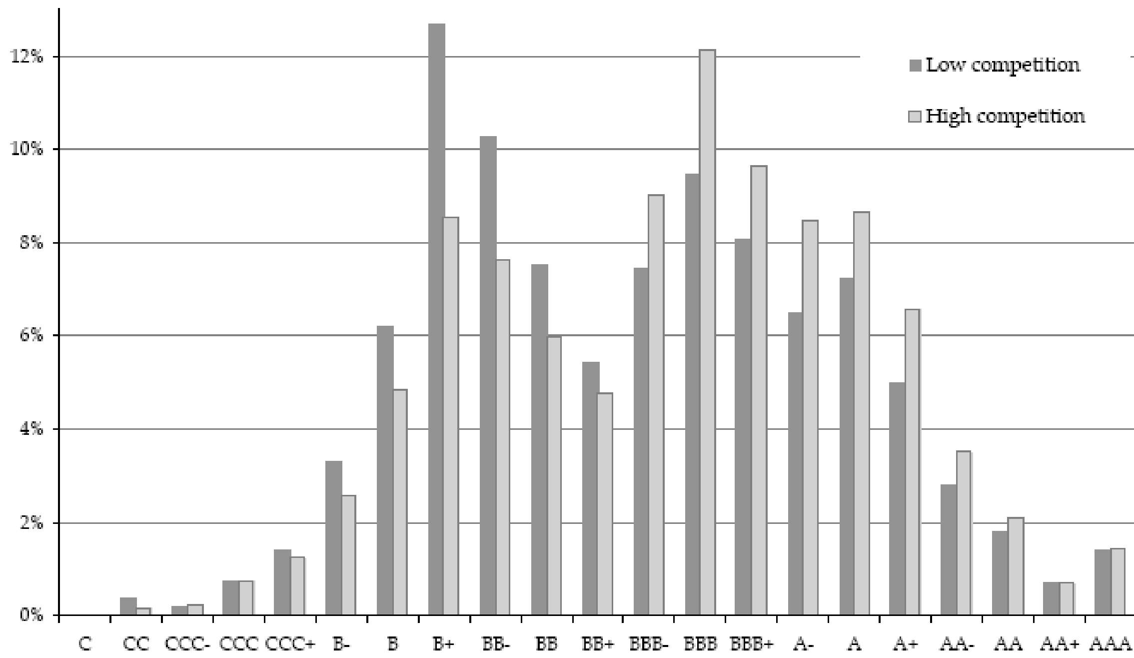
ANNEXE

Figure 2.
Firm credit ratings distribution: high and low competition in the credit rating industry



Source: Becker, Bo and Todd Milbourn (2009).