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Regulating rating agencies

Local power, no solution

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The regulation about to come into force will create arbitrage between national supervisors, stunt international cooperation and fail to solve the problems with ratings themselves

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After months of debate, the European Parliament's comprehensive regulation on credit rating agencies (CRAs) and their rating activities is about to come into force. It is hard to see how it will correct the errors that contributed to this financial crisis, or restore investor confidence.

Lord Turner in his review of the UK and international approach to the way banks are regulated, concluded that there has been a breakdown in rating effectiveness due to, amongst other things, misplaced confidence in the ability of mathematical modelling and ratings being extended to instruments where there is limited historical experience. Commentators have concluded that CRAs simply did not understand the complexity of the structured finance products they rated or, at the very least, that the assumptions on which their rating methodologies were based were incorrect. CRAs themselves have accepted that there had been an over-reliance on ratings. Ratings are meant to indicate the probability of default; investors relied on them as an indicator of liquidity and market value. Finally, concerns have been raised about perceived conflicts of interest and a lack of independence in the credit rating business.

With the aim of making ratings "independent, objective and of adequate quality", regulators on both sides of the Atlantic have stepped in. The US was quick to tackle the issue by adopting the Credit Rating Agency Reform Act 2006, which is now being amended as part of the regulatory overhaul in the US. European regulators began bridging the gap with the US when on April 23 2009 the European Parliament adopted a new regulation on CRAs following a proposal by the European Commission in November 2008. The regulation will soon come into force and be a fundamental change for the way CRAs operate in Europe.

No answer to rating mistakes

Notwithstanding the concerns expressed by some (including the Committee of European Securities Regulators (Cesr) and certain CRA representatives), rating activity in Europe will be subject to a prescriptive rules-based regime. Put briefly, the regulatory oversight will include (i) registration requirements for CRAs, (ii) close supervision of CRAs by the competent authorities of member states, (iii) restrictions on the use of ratings by banks and other financial institutions for regulatory capital purposes to ratings issued in compliance with the regulation, (iv) independence and conflicts of interest rules, (v) disclosure obligations and (vi) operational and organisational requirements.

The introduction of detailed rules on conflicts of interest, compensation for CRA analysts and management, independent directors and public disclosure of rating methodologies, models and assumptions have largely been welcomed by industry. They will ensure appropriate structures to manage conflicts of interest, reinforce analyst independence, enhance rating transparency and help investors make more informed decisions.

However, the rating mistakes made on sub-prime and structured finance investments were not caused by a lack of regulation, nor by the alleged misconduct by CRAs in running their operations. They were made because (by admission of certain CRAs) of rating assumptions which were incorrect. Yet it is the explicit intention of the regulation not to interfere with the substance of credit ratings.

The benefits of the regulation's increased transparency requirements are limited. More disclosure will not protect investors that do not have the ability to thoroughly understand rating methodologies, dissect modelling assumptions and second-guess ratings if necessary. In addition, the regulation does not cover "private credit ratings produced on an individual order [...] which are not intended for public disclosure" (article 2.2(a)). If private ratings are not publicly disclosed, there is a risk that CRAs will not apply their rating methodologies and models consistently when issuing them.

No alternatives to issuer-pay

One of the main criticisms of CRAs is the inherent conflict of interest in the issuer-pay model. CRAs are not paid by those whose interests are aligned with the rating (the investors) but by the arrangers and issuers. The issuer-pay model is intrinsically flawed as misaligned interests within a CRA exist in every rating. On the one hand, to rate the transaction and generate income for the CRA business and on the other, to protect investors by potentially refusing to rate if a sound rating decision cannot be made. Performance-based compensation for analysts and senior management exacerbates the issue.

The regulation attempts to deal with this issue by providing that "[the CRA's] business interest [shall] not impair the independence and accuracy of the credit rating activities" (paragraph 2 of Section A, Annex I) but does not go so far as to prohibit the issuer-pay model. Some CRA representatives have argued that there is no suitable alternative to issuer-pay, however flawed it may be, and that an investor-pay model may result in (i) increased conflicts of interest because of misaligned interests between different types of investors (investors with short positions will have different rating expectations to investors with long positions on the same asset) and (ii) asymmetry of information as only the investors that subscribe to a rating will have access to rating information. Unless rating activity becomes public, fees will inevitably come from issuers and arrangers; the issue will be how the issuer-pay model can be effectively managed, not about finding alternatives. Close supervision and enhanced transparency may help reduce conflicts of interest but will not make such conflicts disappear.

Too-wide powers

The regulation gives member states and Cesr far-reaching powers over CRAs and their activities. The registration process is complicated, involving all member states where a particular rating is used (deliberating through a college chaired by a facilitator) and, at a higher level, Cesr. The authorities of the relevant home member state and, in certain circumstances, the authorities of the other member states where such rating is used, may, if it has been established that a breach of the regulation has occurred, (i) withdraw the CRA's registration, (ii) impose a temporary prohibition on the CRA issuing ratings and (iii) impose a suspension on the use of credit ratings for regulatory purposes throughout the EU or in the relevant member state. The authorities of the member states will also have extensive powers to access documents, demand information and carry out on-site inspections without announcement.

Many of these powers conferred on the authorities of the member states and Cesr may be exercised where the home member state has "established that a registered credit rating agency is in breach of the obligations arising from this regulation" (article 21.1) following notification to the facilitator and consultation with the members of the college but without, at present, a right of the CRA to object or be heard. Inappropriate exercise of these powers has the potential for far-reaching consequences. For example, a national regulator may, in its good faith but mistaken judgment, establish that a breach by a CRA under the regulation has occurred and, on that basis, decide that its national banks must write-off the assets rated by such CRA for capital regulatory purposes.

More regulatory arbitrage

The registration and supervision procedures involve all member states where the relevant rating is used, which may create unnecessary regulatory costs and inefficiencies, including (i) overly long registration or withdrawal discussions between the college and Cesr, (ii) large numbers of member states becoming members of the college, potentially affecting its smooth operation and (iii) interference between the regulators of different member states if they take conflicting decisions or measures. Conflicts between national regulators are likely to arise in the exercise of their supervisory powers. Cesr may then find it difficult to balance conflicting national interests when supervising and mediating.

One of the stated purposes of the European Commission's proposal on CRAs was "to ensure an efficient registration and surveillance framework, avoiding forum shopping and regulatory arbitrage between EU jurisdictions". Regulatory arbitrage – where market participants seek out jurisdictions with lower regulatory burdens to cut costs and increase their competitiveness – creates competition among jurisdictions, which in turn encourages regulators to decrease their scrutiny.

In the case of dissenting opinions with other member states or Cesr, the framework adopted by the regulation makes the competent authority of the home member state responsible for final determinations in respect of registration, withdrawal of authorisation and supervisory measures. In addition, the regulation does not prescribe specific penalties for breach. This is left to member states, raising the potential for disparities between penalties. These issues raise the risk of regulatory arbitrage. In determining its jurisdiction of operations, CRAs are likely to take into account criteria including (i) the sophistication and responsiveness of the member state's regulator, (ii) its ability to cooperate with other regulators within the EU and overseas and (iii) the penalties imposed by the member state's regulator for breach of the regulation.

International cooperation difficult

Cooperation between EU and foreign regulators is important in regulating CRAs. In addition to creating regulatory arbitrage, misaligned and inconsistent rules will disrupt rating activities for global CRAs. In Europe, global cooperation could be hindered because of the regulation's division of responsibility between Cesr and member states. The regulation gives a lot of discretion to the competent authorities of single member states, which may have misaligned interests in respect of international cooperation and enter into conflicting arrangements with overseas regulators on similar matters. A consistent global approach and real-time cooperation between regulators in the implementation and enforcement of regulations is fundamental to restoring investor confidence in ratings. More work is required.

Role of regulation is limited

As noted in the Turner Review, it is important not to overstate the role regulation can play in guarding against certain dangers inherent in ratings. Arrangements that related the level of collateral posted in certain derivative transactions to the credit ratings of counterparties created pro-cyclical market behaviour and practices. For example, over-the-counter derivatives entered into by AIG required it to post more collateral if its own credit rating fell – creating a downward spiral of increased liquidity stress and falling perceived credit worthiness. Indeed, it is difficult to see how such market behaviour, which is inherent in ratings-based investment, can be effectively reduced or eliminated through regulation.

Regulation can in practice create perverse consequences. The regulation's registration process could give CRAs a more official status, which investors may interpret as official approval for the ratings, increasing investor reliance on them contrary to the very objective. Some have suggested that registration requirements will also increase barriers to entry, disrupting competition and leading to a decline in the quality of the industry. But the previous approach of minimal regulation has not worked; further regulation of the credit rating business is required.

It's beyond regulation

The impact that the regulation will have on credit rating business in Europe is big. Many aspects, such as the rules on disclosure of rating information and the conflicts of interest rules, may increase market efficiency and restore investor confidence. Others, such as the lack of due process, the procedural complexities and the perceived lack of global approach, may increase regulatory inefficiencies and costs. It is yet to be seen whether the regulation will prevent some of the rating mistakes that caused market participants to blame CRAs for contributing to the financial crisis. On a philosophical level, perhaps this is outside the scope of regulation generally.

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