COMPETITION COMMITTEE

Competition and Credit Rating Agencies

Series Roundtables on Competition Policy

N° 152

OECD

2010

Unclassified **DAF/COMP(2010)29**

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

05-Oct-2010

English, French

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP(2010)29
Unclassified

COMPETITION AND CREDIT RATING AGENCIES

This document compiles documentation related to a hearing on Competition and Credit Rating Agencies held in the Competition Committee meeting on 16 June 2010. It includes the summary of discussion [DAF/COMP/M(2010)2/ANN3] which was approved by Competition Delegates under written procedure. This compilation is circulated FOR INFORMATION.

English, French

JT03289562

Document complet disponible sur OLIS dans son format d'origine
Complete document available on OLIS in its original format

COMPETITION AND CREDIT RATING AGENCIES

Note from the Secretariat

The Competition Committee decided to hold occasional "hearings" on selected topics which might call for further input from Competition delegates. This initiative results from delegates' perceived need to address strategic issues outside the core competition domain and to improve the dialogue in such areas where competition can be meaningful.

Experts on the selected topic are invited to present their views on what they believe are the important issues in this area, and particularly what issues might involve a significant competition element and would therefore deserve further consideration by the Committee.

The Competition Committee held a hearing on Competition and Credit Rating Agencies on 16 June 2010 with the following experts:

Professor John C. COFFEE, Columbia University Law School (USA)
Professor Karel LANNOO, Centre for European Policy Studies – CEPS (Belgium)
Professor Patricia LANGOHR, ESSEC Business School (France)

This document compiles the documentation related to this Hearing.

LA CONCURRENCE ET LES AGENCES DE NOTATION FINANCIÈRE

Note du Secrétariat

Le Comité de la Concurrence a décidé d'organiser des auditions (« hearings ») occasionnelles sur des sujets choisis, susceptibles de générer des contributions ultérieures des délégués du Comité. Cette initiative résulte de la nécessité perçue par les délégués d'aborder certains sujets stratégiques au-delà des questions clés de concurrence. L'objectif est d'améliorer le dialogue entre responsables publics dans des domaines où la concurrence peut être déterminante.

Des experts dans les sujets choisis sont invités à présenter leurs points de vue sur les questions qu'ils jugent importantes dans le domaine traité, en particulier dans la mesure où elles comportent une dimension de concurrence significative, et, à ce titre, justifier une attention particulière du Comité à l'avenir.

Le Comité de la Concurrence a tenu une audition sur la Concurrence et les Agences de Notation Financière le 16 juin 2010 avec la participation des experts suivants :

Professeur John C. COFFEE, Columbia University Law School (États-Unis),
Professeur Karel LANNOO, Center for European Policy Studies (CEPS)
Professeur Patricia LANGOHR, ESSEC (France)

Ce document rassemble la documentation relative à cette audition.

Visit our Internet Site -- Consultez notre site Internet

http://www.oecd.org/competition

TABLE OF CONTENTS

SUMMARY OF THE DISCUSSION

By the Secretariat

The Chairman of the Competition Committee explained the hearing discussion was held on 16 June 2010 in the context of the Competition Committee's more general discussions about the financial crisis and as a result of a specific interest about infrastructures which support financial markets, and their competition implications.

Chairman Jenny introduced the panellists who had been invited to contribute to the discussion: Professor John Coffee (Columbia University), Professor Patricia Langohr (ESSEC Busines School) and Mr. Karel Lannoo, (Chief Executive at the Centre for European Policy Studies). He also welcomed the participation of Professor Hans-Helmut Kotz, Chair of the OECD Committee on Financial Markets.

At the invitation of Chairman Jenny, Professor Langohr [1] started the discussion by emphasising the important economics behind the Credit Rating Agency (CRA) industry, and outlining the definition of a credit rating. Credit ratings provide an opinion on the relative ability (and willingness) of an obligor to meet financial commitments. They aim to be (i) ordinal ratings on an alpha-numeric scale, (ii) stable, that is, CRAs aim to rate through the cycle, (iii) consistent and comparable across instruments, maturities, industries and countries and (iv) objective and transparent. Ratings deal with defaults and place an issuer or an instrument on a scale from least likely to default to most likely to default.

The current CRA industry started in 1909, with Moody's. By 1924 Fitch and S&P had entered the market, but the industry remained concentrated. Until 1970 the *investor-pays business model* prevailed. There were some regulatory uses of ratings, and demand for ratings was relatively stable. From 1970 – 2001 a switch was made to the *issuer-pays business model*. In 1975 the SEC created the NRSRO[2] status and by 2000 Fitch had become the third global CRA. There was a huge expansion of the role of CRAs due to financial disintermediation[3], institutionalisation of investments and the increasing rate of industry change. From 2002 to today financial innovation and globalisation have extended the role of CRAs even further. 2007 saw the end of the closed NRSRO status. For 35 years only three CRAs achieved the status (some CRAs achieved the status temporarily before merging with one of the dominant ones) and today there are eleven CRAs with NRSRO status.

Fundamental ratings have three functions:

- A rating's original economic function is to objectively *measure the credit risk* of the issuer and to resolve the fundamental information asymmetry between issuers and investors. This assists issuers in accessing funding through markets.

1 See also "The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant" by Herwig Langohr and Patricia Langohr, John Wiley & Sons, 2009.

2 Nationally Recognised Statistical Rating Organisation.

3 Withdrawal of funds from financial institutions in order to invest them directly.

- The second function is to provide a *means of comparison* across all issues of embedded credit risk and provide a consistent global rating scale to help build a portfolio. This is essential for the investor.

- Finally ratings provide market participants with a *common standard* or language to refer to credit risk. A rating is an independent credit opinion expressed in a single contractible measure i.e. it is a measure which is observable and verifiable by all, and can therefore be included in contracts and regulations. This is essential for prescribers i.e. private contracts, investment guidelines and regulations.

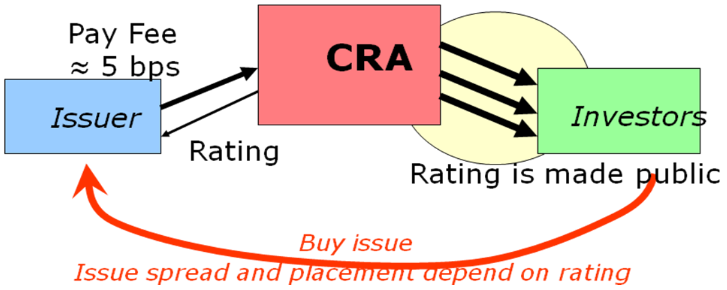
These three functions together provide value to the market. They are complementary, with each function increasing the value and utility of the others. Historically these functions were separated, but fundamental ratings evolved endogenously, eventually providing all three together. The comparability and contractibility functions have important implications on the nature of competitive interaction amongst the rating agencies. The three functions historically were provided by three types of institutions: (i) specialised press and financial press which described specific business conditions, (ii) credit reporting agencies which reported on the ability of merchants to pay their financial obligations, and (iii) investment bankers who put their reputations at stake each time they underwrote a security.

According to Prof. Langohr, there are a number of key intrinsic factors affecting competitive dynamics in this area. Firstly credit ratings are experience goods i.e. the quality of the rating is only revealed ex-post using a large sample. Simply because a default does not occur it does not mean that a good rating should be given. Therefore reputation for quality built on a long track record is the crucial competitive advantage. Secondly investors value comparability and consistency of ratings across geographical segments and instruments. Ratings from a given CRA provide a common standard to interpret risk. Investors are unwilling to spend large resources to interpret many different standards, all else equal, the larger the 'installed base' of ratings from a given CRA, the greater the value to investors. Finally, corporate issuers build a trust relationship with one or two CRAs but are unwilling to be rated by more. However building this relationship involves valuable executive management time. Corporate issuers will value the ratings most trusted by investors to facilitate placement and provide for the lowest spread. Hence, for all the above reasons, the CRA market is a natural oligopoly.

The market for fundamental credit ratings cannot sustain a large number of agencies. The market will remain an oligopoly where CRAs tend to compete *for* the market (to become a standard) rather than *in* the market. However, competitive dynamics amongst even a small number of CRAs can be based on building a reputation for rating quality. This market discipline can also mitigate the inherent conflict of interest in the issuer-pays business model. As entry into the market is so difficult, competition amongst the rating agencies is distinct from other markets. However, it may also occur that they compete fiercely against each other, but not in the rating quality dimension, knowing that if the situation becomes negative it will be negative for all, so that no individual is likely to lose any market share.

There are two possible business models that CRAs can use. One is the subscription based model (investor-pays), where users such as institutional investors and broker-dealers are charged for ratings. The other, followed by the big three agencies, is the issuer-pays pricing model. (See Diagram 1) In this latter model, the fees are primarily paid by the issuers whose securities the CRAs rate, despite the fact the primary commitment of the CRAs is to the investment community. Prior to 1970, the CRAs provided ratings free of charge to issuers and sold their publications to investors for a fee. The subscribers-pay model however, turned out to be unsustainable. While it guaranteed the CRAs independence from the issuer being rated, it did not provide sufficient revenue to support their operations, as the publications could be easily copied.

Diagram 1: The essential conflict of interest: the issuer-pays business model



During the US recession of early 1970s, the dynamics of the industry changed. Issuers became willing to pay for a rating in order to demonstrate to the market that they were of sound credit. With the demand for ratings rising, the CRAs found themselves able to charge a fee for their services. This practice grew to the point where, by 1987, nearly 80% of S&P's revenues came from issuer fees. The balance came from selling research and ratings information to large institutional investors, corporations, and libraries.

The justification for charging issuers is two-fold. Firstly, issuers receive substantial value through the publication of independent ratings that gives them access to public debt markets and improves the cost of capital. Secondly, rating agencies need these revenues to be able to sustain the costs of their activity.

While both issuers and investors rely on ratings, issuers have a higher willingness-to pay than investors. This is due to two attributes of ratings for investors: (i) non-excludability of rating information and (ii) redundancy of any specific rating.

Prof. Langohr noted that there are a number of factors that disrupt market discipline and reputation building. The first is regulatory uses of ratings. Ratings have become so embedded in guidelines and regulations that the safety judgement of an investment has de facto been outsourced to ratings (See Diagram 2 for a small number of examples of regulatory uses in the US). Some investors, subject to restrictive investment guidelines or regulations, may even prefer a slightly higher rating even if it is imprecise or biased. Many structured finance instruments were produced for regulatory arbitrage purposes and benefitted from opacity. Two further disruptions to market discipline include the statutory regulation of CRAs, and excess liquidity. There are, however, a number of ways in which the performance of ratings could be enhanced.

- *Explicit regulatory reliance on ratings should stop altogether:* it gives ratings a force of law, whereas they are only opinions.
- *The link between investors and CRAs should be re-established*: CRAs need to serve investors and investors need to monitor/rate the CRAs. CRAs should enhance their reputation by refusing to rate if information is not sufficient. The justification that an investment is safe should be on the decision-makers side i.e. the investor.
- *Regulation should monitor output i.e. performance*: monitoring input provides the wrong incentives, does not align the interests, stifles innovation and gives a wrong sense of security.

One possible solution is the adoption of a *platform-pays model* as this would solve the issuer-pays conflict, could maintain the contractibility and could enhance competition if the regulator choosing the CRA is able to evaluate quality ratings and reward this choice. However, a lot of faith would be put in the regulator, and as the platform serves as a substitute mechanism for the market it is still delegating the safety decision of an investment to the platform. Another solution is the long-term incentive structure, in which issuers pay for the rating now and the CRA receives its fee ex-post, i.e. after the performance has been observed. However it is difficult to judge the performance of an individual rating, and performance is not clear cut. While the costs are incurred immediately, the rewards may accrue much further down the line. This may bias choices in favour of cutting costs, and performance incentives may not be strong enough. In addition it is questionable whether there would be enough financially viable CRAs.

Diagram 2: Examples of ratings embedded in US regulation

Year	Ratings Dependent Regulation	Min. Rating	How many?	Regulator/ Regulation	Use
1936	Prohibited banks from purchasing "speculative securities"	BBB	Unspec.	OCC, FDIC and Federal Reserve joint statements	Prudence
1982	Eased disclosure requirements for investment grade bonds	BBB	1	SEC adoption of integrated disclosure system	Easier Market Access
1984	Eased issuance of non agency mortgage backed securities	AA	1	Congressional promulgation of the secondary Mortgage Market Enhancement Act of 1984	Easier Market Access
1989	Allowed pension funds to invest in high rated ABS	A	1	Department of Labour relaxation of ERISA restriction	Inv. Protection
1991	Required money market mutual funds to limit holding of low rated paper	A1*	1	SEC amendment to rule 2a-7 under the investment company act of 1940	Inv. Protection
1994	Imposes varying capital charges on banks and S&Ls' of different tranches of ABS	AAA and BBB	1	Federal Reserve, OCC, FDIC, OTS Proposed Rule on Recourse and Direct Substitutes	Capital Req.

Professor Coffee focused his presentation on the failings of the credit ratings market and how the CRAs should be reformed. The end of the financial crisis demonstrated not only the inadequacies of financial technology i.e. asset backed securitisation, but also the failure and conflicted position of the CRAs. It is clear that lax regulators and highly conflicted CRAs missed (or averted their eyes to) a significant decline in credit quality in the U.S. housing market. (See Diagram 3)

Diagram 3
Subprime Mortgage Lending 2001 -2006: showing the rapid deterioration in credit quality associated with subprime mortgages

	Low/No-Doc Share	Debt Payments/Income	Loan/Value	ARM Share	Interest-Only Share
2001	28.5%	39.7%	84.0%	73.8%	0.0%
2002	38.6%	40.1%	84.4%	80.0%	2.3%
2003	42.8%	40.5%	86.1%	80.1%	8.6%
2004	45.2%	41.2%	84.9%	89.4%	27.3%
2005	50.7%	41.8%	83.2%	93.3%	37.8%
2006	50.8%	42.4%	83.4%	91.3%	22.8%

Following empirical research it is clear that securitisation led to lax screening by loan originators. This is to some extent a classic "moral hazard" problem, because at each step non-creditworthy loans were made or resold by those who did not expect to bear exposure to them for long. Investment banks bought unsound loans from loan originators knowing they could securitise them on a global basis, provided they could obtain "investment grade" ratings from NRSRO CRAs. This was facilitated by a relaxation in standards by CRAs for the following reasons:

- *CRA clientele*: the nature of CRA clientele changed with fewer investment banks bringing deals and instead threatening to go elsewhere. (See Diagram 4)

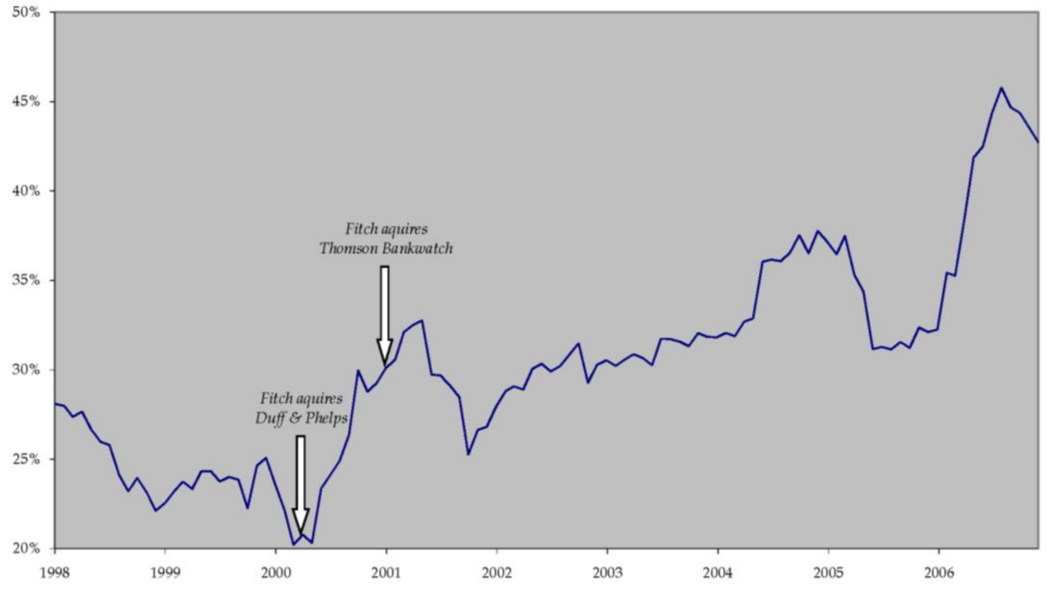
Diagram 4
MBS Underwriters in 2007: A Very Concentrated Market

Rank	Book Runner	Number of Offerings	Market Share	Proceed Amount + Overallotment Sold in US ($mill)
1	Lehman Brothers	120	10.80%	$100,109
2	Bear Stearns & Co., Inc.	128	9.90%	$91,696
3	Morgan Stanley	92	8.20%	$75,627
4	JP Morgan	95	7.90%	$73,214
5	Credit Suisse	109	7.50%	$69,503
6	Bank of America Securities LLC	101	6.80%	$62,776
7	Deutsche Bank AG	85	6.20%	$57,337
8	Royal Bank of Scotland Group	74	5.80%	$53,352
9	Merrill Lynch	81	5.20%	$48,407
10	Goldman Sachs & Co.	60	5.10%	$47,696
11	Citigroup	95	5.00%	$46,754
12	UBS	74	4.30%	$39,832

1. The top 6 controlled over 50% of this market.
2. The top dozen over 80%.

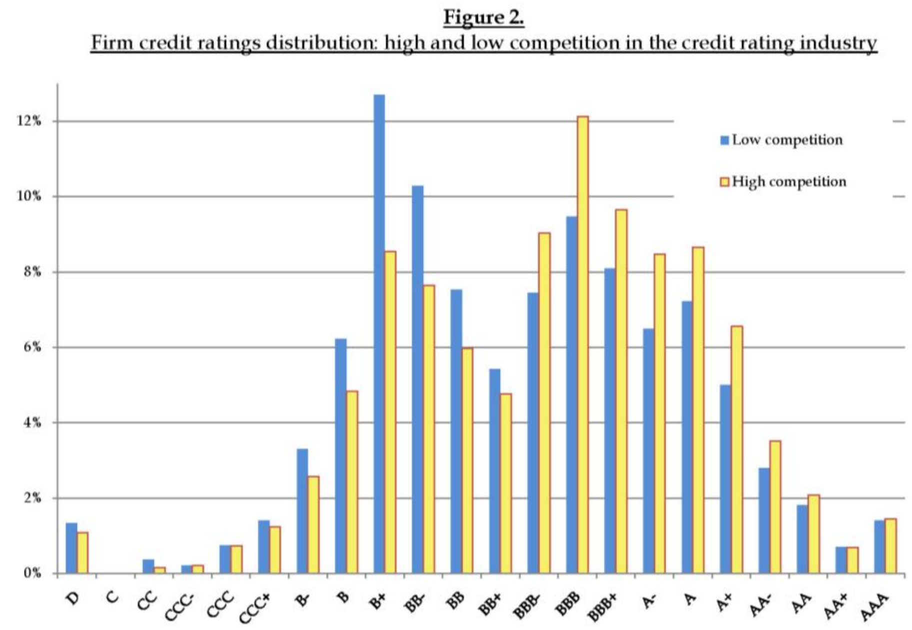
- *Fitch Ratings*: as Fitch became a serious competitor, grading inflation soared. By 2004 Investment Banks could credibly threaten to replace either Moody's or S&P with Fitch. (See Diagram 5).

Diagram 5
Becker and Milbourne: Reputation and Competition



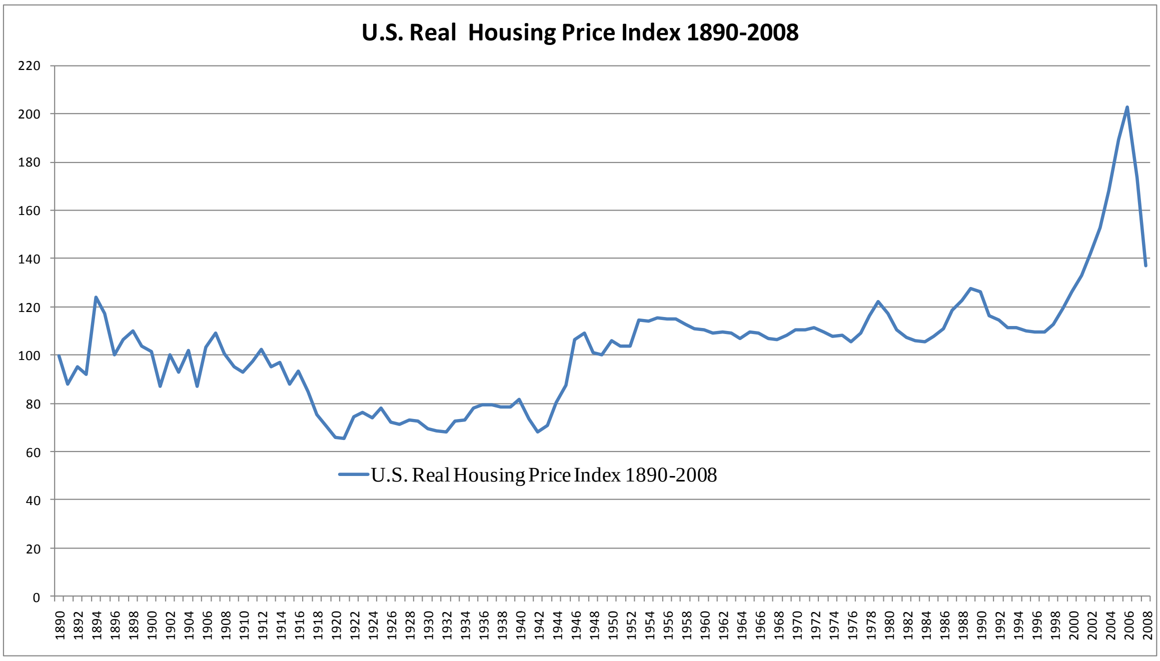
For many commentators, competition is exactly what the market for credit ratings needed. However, Becker and Milbourne find that it in fact led to a significant inflation in the ratings. The percentage of investment grade ratings went up with greater competition and the percentage of non-investment ratings went down, in both cases for every rating. (See Diagram 6)

Diagram 6: Grading Inflation and Fewer Low Grades Under Competition



- *Housing prices*: CRAs wrongly assumed general housing price levels would not fall, even if the rate of mortgage default increased. (See Diagram 7)

Diagram 7: The US Housing Bubble



- *Due diligence*: as investment banks did not want adverse information reaching the rating agencies, factual verification of the key elements in the CRAs valuation model declined.

The SEC's "Staff's Examination of Select Credit Rating Agencies" (2008) reported that CRAs "did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated." In the recent past (up until around 2000), due diligence was part of the rating process, as underwriters hired third party "due diligence firms" (of which Clayton Holdings and the Bohan Group were the best known) to sample and test morgage portfolios before the underwriter would buy them from the loan originator. However, after 2000 as the quality of the collateral in the subprime market began to deteriorate, underwriters reduced and then stopped their use of due diligence firms. Arguably, this was done to avoid letting the red fags that the third party firms were raising come to the attention of the rating agencies; in short, both the underwriters and the rating agencies tolerated a willful blindness to the decline in creditworthiness.

It has been argued by some that the CRAs went wrong because their valuation models were flawed. However, more recent evidence indicates that in fact they systematically departed from their valuation models, making discretionary upward adjustments. Griffin and Tang studied 916 CDOs issued between 1997 and 2007, and found that these discretionary adjustments inflated the size of the AAA tranche, increasing it by an additional 12.1%. They reported that "*only 1.4% of AAA CDOs closed between 1997 and 2007 met the rating agency's reported AAA default standard*" and they "*estimate that the AAA tranche would have been rated BBB on average*" and the aggregate overvaluation on the 916 CDOs they analyzed came to $86.2 billion. Although adjustments went both ways, 84% were upward.

In May 2010, the New York Federal Reserve Bank Staff Study, which examined 60,000 plus MBS securities between 2001 and 2007 (or 90% of all deals over that period) reported that risk adjusted subordination declined significantly from 2005-2007, thereby inflating the AAA tranche. The most striking finding was that deals with a high share of "low doc" loans perform disproportionately poorly, even relative to other types of risky deals. The conclusion drawn was that during a "boom" period, concern about protecting reputational capital fades.

Prof. Coffee put forward three models for reform, all of which aim at curbing the issuer pays business model:

- *Government as Umpire*: Under the Franklin Amendment a Credit Rating Agency Review Board would choose the initial rater for structured finance ratings, and the issuer could then purchase additional ratings. The Franken model contemplates a lottery or rotation system and the volume of ratings may preclude individual choices. However, rotation or lottery systems eliminate any incentive to compete based on the quality of ratings. Accuracy as a standard might take a decade (or more) before sufficient data existed on new entrants, thus favouring the Big Three.

- *Jumpstarting a "Subscriber Pays" Model*: Either (i) institutional investors are required to obtain a rating from a non-issuer paid CRA; (ii) issuers who hire a CRA must pay for a second rating from an "investor owned" CRA (Grundfest and Hochenberg); or (iii) the Government Agency Selects the CRA preferred by a poll or vote of investors. The goal of this model is to induce CRAs to compete for investor favour. However, there is only one 'subscriber pays' CRA in the US which indicates that institutions will not pay voluntarily. In addition, conflicts remain as some investors want to rationalise the purchase of risky, high yield securities. There are also questions over whether the deal arranger could reimburse the investor for its rating expenses, whether investors would form CRA collectives and whether it matters if all credit ratings become private under this model.

- *Government Utility Model*: the government prepares its own ratings, but issuers remain free to purchase ratings. However, there are issues over whether a government agency may disfavour an important local company with a junk rating (e.g. GM in the US or Volkswagen in Germany). Politically accountable CRAs may be subject to unique pressure. Does, for example, the reaction to the downgrading of Greek sovereign debt reveal a 'blaming the messenger' reflex? Can a civil service agency compete effectively with higher paid private CRA analysts or would a European-wide "public" CRA do better?

There is another issue related to whether CRAs should be deregulated, and whether the "licensing power" of the Big Three explains their dominance. The objections to this thesis are that (i) the Big Three were dominant decades before they had regulatory licensing power; (ii) they are also dominant in Europe; and (ii) since the 2006 Act, virtually any competent applicant can become an NRSRO. Yet still the Big Three reign. It is also questionable whether a "do-it-yourself" credit analysis is feasible for CDOs and other opaque products. Given the public goods, or 'free rider' problem and the history of the 1970's, a 'subscriber pays' model may not work without government support or legal requirements. Economies of scale in the production of information may naturally produce a concentrated ratings marketplace.

Prof. Coffee asked: What, therefore, should ESMA (the European Security and Markets Authority) do? The problem is that administrative oversight of a complex and technical process often deteriorates into "check the box" procedural review. It is also doubtful that regulators fully understand or can evaluate CRA valuation models. Worse, if they have such power, they may penalise CRAs for politically insensitive downgrades.

Hence, the priority (based on Griffin and Tang's data) should be the surveillance of upward discretionary departures from the CRA's own valuation models. SEC Rule 17g-2 (only adopted in 2009) now requires an NRSRO to document the reasons for any material deviation from its quantitative valuation model. Other useful reforms include (i) fee contracts with a mandatory, multi-year monitoring fees to incentivise CRAs to update or downgrade their ratings, (ii) an 'equal access' rule to improve competition by ensuring all information provided to any CRA is provided to all qualified CRAs, (iii) regulatory rules encouraging the use of 3rd party due diligence firms to conduct factual verification, (iv) prohibition of 'self-rating' and 'rating shopping'.

Mr. Lannoo's presentation focused on financial regulation and he started by emphasising that the debate on the role of CRAs in fact predates the crisis. Following the South-East Asia crisis of 1997, and the dot com bubble of 2001, the delayed reaction of the CRAs to the public finance situation of affected countries was strongly criticised. Mr. Lannoo's presentation covered four aspects; (i) CRAs today, (ii) European market for CRAs, (iii) EU Regulation on CRAs and (iv) overlapping regulatory debates.

(i) CRAs today

The credit rating industry is a global business, but controlled by only a few players. Two of US parentage (Moody's and Standard & Poor's) control over 80% of the market. Fitch was the third entrant into the market, and its ultimate owner is headquartered in Paris so in principle European. With Fitch, the three leading players control over 94% of the global market. Since 2007 all three groups suffered a serious decline in revenue and profits. However it was Fitch which suffered the most, suggesting that more competition may not be the answer to improving the status of the market. Unlike the bank-driven model which is common in Europe, the US relied on a capital market driven model which relies on a multi-layered system to make it work. As there has not been much of a capital market in Europe until recently, banks have essentially performed the credit risk analysis. Possibly as a result of the reputational strength of the US capital market model, the credit risk analysis function of European banks declined, creating a captive market for an essentially US based industry.

(ii) European market for CRAs

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

Under the Basel II approach, risk weightings are based on CRA assessments and banks are required to set aside a proportion of capital to cover potential losses. The amount of capital increases according to 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, under 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 does not have to set aside capital for these assets. However, it can be argued that Basel II creates an artificial market for CRAs.

As no EU regulation existed at the time of the 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. Therefore on the one side is the Basel II CRD approach, and on the other the ECB liquidity approach. However, the use of CRAs 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). On that basis, the ECB decides upon acceptance of securities and the applicable haircut.

(iii) EU regulation for CRAs

Prior to the EU regulation[4] for CRAs coming into force the EU Commission asked the Committee of European Securities Regulators (CESR) for technical advice on market practice and competitive problems related to the CRAs. While the CESR concluded that CRAs largely complied with the IOSCO[5] code, concerns remained regarding the oligopoly in the sector, the treatment of confidential information, the role of ancillary services and unsolicited ratings. The EU regulation, which came into force 20 days after its publication in the Official Journal on 7 December 2009, stipulates (i) CRAs must be registered and subjected to ongoing supervision, (ii) a definition for the business of the issuing credit ratings, (iii) rules for tighter governance, operation (e.g. compensation) and conflicts of interest, and (iv) CRAs must disclose their methodologies, models and rating assumptions.

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. 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 rating agencies registered in a third country can only be used if they are not of systemic importance to the EU's financial stability, 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.

4 Regulation 1060/2009 of 16 September 2009, OJ 17.11.2009

5 International Organisation of Securities Commissions.

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 a 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.

(iv) Overlapping regulatory debate

The EU's regulation does not alter the fundamental problem that CRAs pose from a public policy perspective i.e. (i) the oligopolistic nature of the industry; (ii) the inherent conflict of interest through the issuer-pays principle; (iii) 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. Four other solutions can be put forward including:

- *Investor pays model*: under this model policy ratings should be paid for by investors and investors and CRAs should be given free and complete access to all information about the portfolios underlying structured debt securities.
- *Platform pays model*: a form of clearing house for ratings, complemented by prudential oversight of ratings' quality to control for bribery.
- *Payment based on results*: taking inspiration from the bonus debate, this model suggests deferring a part of the payment to CRA analysts based on results, with the performance of the securities rated being the indicator for the fees CRAs charge.
- *Partnership structure*: this model would operate in a similar way to the audit sector, which is regulated by an EU directive setting tight rules on governance and quality control, and limiting the degree of non-audit services audit firms can perform for an audit client.

Mr. Lannoo concluded that a deeper analysis of the mechanics behind the credit ratings market is required as the EU legislation that was adopted does not address the fundamental problems of the industry. Instead it gives rise to side effects; the most important of which is the supervisory seal. One positive aspect of the EU regulation is the opportunity for DG Comp to increase its activity in this area. However, given the depth of the financial crisis, and the central role played by ratings agents, certainly in the EU, a more profound change is needed, towards the 'platform-pays' model or a long-term incentive structure.

Professor Kotz reiterated the point made by Mr. Lannoo that the issue of credit rating agencies' capacity to appropriately evaluate default risks has been in discussion for 10 years (specifically in 1998 after the Asian crisis as well as the accounting scandals in the US and Europe in 2001). These failures are inevitable given the limited capacity to precisely gauge upcoming problems with an eye on the ability as well as the willingness to pay on the side of debtors. CRAs are frequently used as scapegoats, but at the same time while functional substitutes (in detecting credit problems) such as banks, interest-rate spreads, CDS-premia or structural, distance to-default models (of the Merton-type) may detect problems slightly faster, they do not perform much better. Given this systematic inability he public sector therefore should also be much more careful in relying on CRAs, referencing rules and regulations to their judgment. Essentially, this referencing implies that CRAs become publicly acknowledged certifiers (seal of approval). Mr. Kotz emphasised the point highlighted by Prof. Coffee that the industry structure naturally leads to a narrow oligopoly. Consequently there would be no advantage in having numerous rating agencies as this would lead to a reduction in information value for investors, and therefore a loss of the core function of rating agencies. With regard to remedies two issues were highlighted; the importance of (i) transparency, i.e. removing the opaqueness and monitoring the monitors and (ii) diversification, i.e. the use of more evaluation mechanisms rather than one opinion exclusively. Mr Kotz also emphasised that while some commentators had highlighted the possible systemic risk of credit derivatives ex ante, these commentators constituted a small minority and were frequently derided. Of course in the end the consensus opinion was proved wrong. However, it took some considerable time before the extent of the crisis was truly accepted, during which many in the policy-making community were in a mode of denial. This experience indicates the importance of acknowledging dissenting views and judgments in policy formulation. Going forward referencing to CRAs should be used less frequently and with appropriate caution in formulating public policies. Mr Kotz also emphasised that this issue highlights the usefulness of an effective collaboration between the OECD Committee on Financial Markets and the OECD Competition Committee in supporting well made cases and bringing them to the public debate.

Mr Blundell-Wignall, Deputy Director of DAF, summarised that there were three points of agreement; (i) there is a problem, (ii) there is discontentment about what regulators are doing in terms of reform, (iii) there is a need to involve the investor in the process of due diligence, perhaps through an investor pays model. Mr Blundell-Wignall's intervention covered three aspects of these points;

- *Abuse:* There is a clear case of abuse as (i) credit ratings have a very spiky impact on markets, i.e. when a downgrade occurs in a relatively calm market, this triggers a disproportionately large effect. This was evident in the case of Greek government debt, and illustrates that the information is not being processed in a sufficiently clear and consistent way, (ii) there is asymmetry in the market, meaning that when there are upgrades or inflation the positive effect is much less compared to the negative connotations of a downgrade, and (iii) there is a problem related to the interaction between regulation and competition authorities and the pro-cyclical nature of ratings. A downgrade causes significant liquidity effects on the market, which partly contributes to the spiky behaviour. However credit ratings tend to cause a lag, meaning that equity prices are a better predictor of what is happening with regard to a company or structured product.
- *Structure of the market*: The abuse appears to be related to the structure of the market which is typically oligopolistic. Further barriers to entry not yet discussed include (i) regulations which create a stamp of approval issue benefiting incumbents, (ii) pension fund mandates which require financial products to attain a certain level before investment can be made and (iii) loan covenants which will not accept as collateral any trading of security that is below a certain level of credit. These three barriers are perhaps more important than the 'reputation' barrier, especially given the quality of the ratings and advice has been demonstratively appalling. The reason the structure of the market caused such a problem can be attributed to the 2004 explosion of leverage in investment banking. This was related to some regulatory changes outside of the area of CRAs, in particular the SEC agreeing to supervise investment banks on a consolidating entities basis, which allowed the leverage in investment banking to explode. This boosted the credit default swap market, securitisation etc, and the fact banks required less capital also contributed to increased leverage. The market was therefore tested with an explosion of potential revenue outside of what CRAs usually do. The oligopolistic structure, faced with an explosion of the overall market and attempts to maintain market share, led to an inflation of ratings by CRAs in an attempt to win mandates from banks to rate the new products. The structure of the market was therefore a cog in the machine and contributed to the failure of the credit rating process.
- *Reform*: Whatever the model used, if 'rubbish' is put in, then 'rubbish' will come out. The models use proprietary information, but without any requirement to carry out fundamental research or verify and substantiate the information going in. The infrastructure of these models can be compared to broadband network i.e. the real issue is the access to the network and competition should be between content not access to a certain model. Models should therefore be open and free, or available for only a small fee, and competition should focus on what is going

> into the models rather than access to the models themselves. In addition to freeing up these models, there should also be a way to tap into the vast amount of knowledge held by brokers, both in stocks and credit products. This would allow an alternative view to be put forward, in addition to offering competition against the CRAs.

In summary, the reforms related to an issuer pays model should be welcomed, in addition to fee remuneration vested over time, disclosure about ratings, their history and the outcomes, a ban on conflicts of interest, and the encouragement of competition on content. Finally it should be emphasised that the CRAs were not the cause of the crisis, as countries such as Australia, Canada and Brazil all used the same CRAs and did not suffer a financial crisis. However, there is a case for much better co-operation between competition agencies, regulatory agencies and stock exchanges etc. To date these have been operating in their separate worlds, while in fact they have an important interaction effect and should be working together.

A delegate from Italy commented that the panel had been very interesting, and asked two questions. Firstly, while supporting the suggestion that investors should pay, all of us are investors so who exactly should pay? A comparison was made between CRAs and the auditing business, with the distinction that auditors are paid by the company they audit and not by the investor, and auditors have successfully eliminated the conflict of interest that CRAs have. So why should there be a difference in the field of credit ratings? Secondly, reference was made to the testimony given by Prof. Coffee at the US senate last year in which he stated that CRAs are not subject to liability costs or effects i.e. they cannot be brought to court to justify their claims. However, in the auditing business liability is associated with fraud and not with making an error in assessment. Therefore what burden of proof would there have been if the CRAs had been subject to liability? Would we sue them today for what they had done if they had been subject to liability?

Prof. Coffee responded that CRAs and auditors are both financial gatekeepers responsible to investors, but paid by the issuer. However one difference is that auditors have been subject to financial liability for a long time, and it is well established that a percentage of their total revenue will be allocated to paying either litigation settlements, or paying the cost of defending litigation. This motivates the auditor not to make risky judgements or defer excessively to the issuers preferences. In the US liability is for fraud, not for simple negligence, at least under the federal securities laws. However, the House of Representatives and the Senate are currently debating two different provisions, although no agreement has been reached yet. Under the House of Representatives bill, liability would be imposed on the CRAs simply for gross negligence alone. The Senate provision (drafted by Prof. Coffee) would remain with a fraud standard, and the case would go forward to court and would not be dismissed pre-trial if it could be alleged with particularity that there was insufficient verification and no reasonable investigation had been conducted. This would create a strong statutory incentive to carry out sufficient verification, or hire a third party firm to carry out due diligence. The unique aspect of CRAs is that they currently carry out no factual verification and this has to be reformed.

A delegate from the European Commission (the ‘Commission’) started by emphasising that an oligopolistic market does not necessarily create a competition problem. As the speakers demonstrated, where competition existed in the market, this actually led to an inflation in the ratings, indicating that competition is not the real problem. In considering the market, the Commission has not found any competition infringements and the issues are more relevant to the regulatory domain than the competition domain. The delegate highlighted two key points. Firstly under the existing regulation adopted last year and described by Mr. Lannoo, CRAs will be registered as of September 2010. This regulation will create an obligation for disclosure of methodologies and models in addition to storage and central depository of the ratings, and a requirement for internal control mechanisms for quality.

Secondly, in a new proposal issued in early June 2010 a European supervisor would be created for the first time, and this supervisor would have powers similar to that of a competition agency. Therefore the supervisor would have far reaching investigatory powers, in addition to the power to propose to the Commission the imposition of sanctions or fines. However, these powers would only be supervisory and all competition powers would remain with DG Comp. One interesting element from a competition viewpoint is the equal access rule for structured finance products touched upon by Prof. Coffee. This rule would require issuers to provide competing agencies rating those products with free access to the disclosed information.

The work on CRAs is ongoing and the Commission has announced it will consider the possibility of having a European rating agency, which would be the same structure as the utility model discussed by Prof. Coffee, or having independent public entities carrying out the ratings. The sovereign debts rating will also be considered, and there will be further reflection on the current leg of alternative benchmarks or substitutes. With regard to stock market prices, this relates to the issue on third party due diligence and therefore there is further thinking to be done in this area. There is also an upcoming review of the capital requirements directive that provides for the use of ratings for risk related assets. Therefore many of the issues that have been discussed today will be addressed by the Commission in the months and years to come.

A delegate from Egypt referred to a recent ruling which stated that a company could use auditors for up to three years, but then the auditors should be replaced by another firm. This ensures that the auditor does not remain with the company long enough to become part of their decision making. The delegate supported the idea of CRAs being registered in Europe. Most CRAs visit a company for a short period e.g. a couple of weeks, carry out some interviews and base their assumptions and rating decisions for the full following year on those short interviews. This mismanagement or lack of information was evident in the Asia crisis. There is also an important role for the central banks and governments here, and the real estate problem in the US was self-propellant. The more loans that were made without supporting documents, collateral or payment, the more demand there was on the real estate, until the point of total saturation resulting in no new demand for new loans. Restrictions should therefore have been put in to ensure that no one was able to go beyond 35% of their income on loan instalments. In fact, in some cases loan instalments of 50% of an individual's income, plus interest, were granted. The banks have also been restricted, forcing them to go beyond a certain percentage of their deposit or asset base into the lending of any section of the economy, so they are not exposed to only one segment. This was evident in corporate and investment banking; and when the focus was on corporate banking, the banks were in a stronger position than when the investment banks took over. The issue with investment banking is that bonuses are based on transactions, and transactions are bought and sold while the credit risk is still alive. However, bonuses are paid up front, and the investment banks are not liable for the transactions as they are no longer on the balance sheet or the books.

A delegate from Portugal summarised the 'why should we do anything in the first place' approach. He commented that CRAs provide a useful service of processing information about firms and financial instruments in such a way as to lower transaction costs for those people wishing to use those instruments or to invest. The issue therefore concerns the output of CRAs. They provide an opinion based on all the data that is available. In general this data is available to the public at large, but there is some data which is available only to bankers and regulators. The delegate questioned whether we are asking too much from a CRA to always be right and not make any mistakes, as obviously the biggest mistake arises when there is a 'bubble'. The bubble is very difficult to deal with at the beginning, and therefore it is unfeasible to expect CRAs to detect all the problems. In addition, if an official credit rating is given, this could compound the problem as people will rely more and more on the official rating, who will also make errors of economic policy, just as central banks and the ministers of finance did.

In response to the issues raised, Prof. Langohr highlighted that there are credit ratings based on market implied information and it has been shown that these are often better predictors of default than credit ratings issued by the fundamental CRAs. However, there are complementary roles to play. CRAs do have private information as many of the issuers in the corporate segment have a relationship with the

CRAs. This allows CRAs to gauge (i) willingness to pay, (ii) the future strategy of the firm, and (iii) risk factors, which are all areas that cannot easily be publicly disclosed. If the model was made transparent then CRAs would not exist as there is no one-to-one mapping from the information that is available, to the unique rating. In essence it is a case of trying to predict the future, and the role of the CRAs is to make a judgement call on this at a certain point in time. Therefore both the CRAs and market implied information should co-exist, but it is important to emphasise that they are complementary and not substitutes.

Prof. Coffee commented that there were two themes to the questions; (i) do CRAs do anything valuable or are they an unnecessary government created body that exits on its licensing power and (ii) asset bubbles occur and scapegoats should not be created for inevitable occurrences that will happen from time to time. On the first theme there is a well developed empirical literature stating that CRAs do add value. It may be that the credit defaults swap, bond and equity market provide valuable information, but there is literature showing that credit ratings provide additional information that is not picked up in the credit default swap or bond yield information. For that reason there is some value to them and it should not be assumed that they will wither away, or should be abolished. As regards the asset bubble argument, this point is more visible in the US, but there were many people who made billions of dollars betting against the real estate back mortgage securities market beginning in 2005 and 2006. It took two to three years for the bubble to burst, but those who had the incentive to do their own independent investigation discovered the truth and became very rich. The reality was thus knowable to those who searched for it, but inflated ratings did permit institutions that were remote or less sophisticated to miss the decline in the quality of the collteral. Therefore conflict of interests did distort the value of the CRA. In summary regulators should develop independent standards of credit worthiness and not rely on credit ratings for regulatory purposes. In terms of the investors' market place, they do want and need credit ratings for a variety of reasons and they would be better served by a platform or subscriber pays system i.e. one in which CRAs have to compete for the favour of investors rather than for the favour of the issuer. If the incentive is right, much less regulation is needed. If the incentives are wrong it is possible that no level of regulation will truly work and that is why the focus should be on the subscriber or platform pays model.

Mr. Kotz made four remarks in response; (i) there is convincing evidence that CRAs are not outperforming other substitutes and that is the reason why regulators should be careful when falling back on them, (ii) CRAs results can, as a rule, be replicated with public information so the evaluation value they produce is not overly impressive, (iii) the EU, with its initiatives to produce transparency in terms of evaluation methods and results, is taking the right approach, but perhaps more action could have been taken six to seven years ago when the same proposals were tabled, and (iv) the crisis is not simply concerned with credit evaluation and the macro-prudential or systemic dimension is obviously of the essence.

Mr Lannoo commented briefly on his reservations regarding the issue of a public funded body in Europe. This would only work if a very strong structure were put in place, for example that of the European Central Bank (ECB), to ensure independence. However, as the ECB's financial support to southern European countries even that model is not really a workable alternative. On the issue of registration, it is useful to have a formal licence in the form of a registration in the EU, but it is questionable whether all these regulations can come through at European level and whether the regulators can cope with all the work. Following the crisis it is therefore key to ensure market mechanisms and discipline are maintained, but at the same time without overburdening the regulators.

A delegate from Australia commented on conflicts of interest and misaligned incentives between ratings agencies and uses of their services, the investors and the fact there appear to have been conscious decisions to override the outputs of particular models that have been used. But what are the consequences and the role for the investor in this context? Investors still need ratings, so they still need to rely on the CRAs. In addition, as there are few CRAs in the market, the actual opportunity for investors to switch to alternative ratings, which could be viewed as a form of punishment within the market, seem quite limited.

The delegate then asked the panel for its views on whether there is a role for greater competition in this market to allow investors to have more choice, either for in the CRAs they use or as a complement to greater regulation.

The Chairman reiterated the related question by Prof. Langohr and asked her to expand on whether the investors model would generate for ratings agencies the same kind of information that is currently available and if not is there any error or default in the investors model that will change the performance of the CRAs?

Prof. Langohr responded that the investors' role is crucial in order to enhance the quality of the ratings, and rather than have a regulatory body monitor the CRAs, it should be the investors who do the monitoring. CRAs and IOSCO have codes of conduct and investor associations such as SIFMA (Securities Industries and Financial Markets Association) should rate the CRAs on different dimensions of the codes. Historically a European code of conduct for CRAs existed, under which CRAs had to comply or explain why they did not comply. However, rather than enforcing voluntary disclosure, investors should evaluate the CRAs and express how well they think they are doing each area that really matters and adds value to investors. This would perhaps force the CRAs to provide new measures to indicate their confidence levels for a rating. Ratings are simply an opinion on a probability of default so AAA ratings were given to structured finance instruments, despite the fact that the data they were basing this assessment on was two to three years old. In addition these products had not yet witnessed a breakdown of the markets. If more information was provided on these products, the quality would be very much enhanced. In the structured finance market, the competitive dynamics could be described as a 'race to the bottom', i.e. CRAs were racing against each other in order to have the criteria that would allow them to provide the largest AAA tranche, which increased the incentive to dismantle the existing regulatory standards. If CRAs are monitored carefully, including by investors, they would still compete but on the quality dimension. However, for the investor pays model to work it would be very difficult not to know what the ratings of the different CRAs are on a given product, and it is not easily feasible for them to remain in the private domain. In addition, the issuer pays model results in contracting on ratings, which is not a preferable result.

Prof. Coffee commented that a point of actual disagreement had now been reached and that one thing the crisis showed is that self regulation of CRAs failed badly. The IOSCO code was well intentioned, but it did not do enough as it did not curb the strong self interest to inflate ratings in response to the need to hold market share. The issue of 'will we get disclosure about the performance' is the reason for regulatory agencies. A regulatory agency can receive information from each of the CRAs to produce comparative performance statistics by asset class on ratings, real estate-backed market securities, and residential, commercial backed securitisations. The SEC is currently undertaking this exercise and a real convergence between the US and Europe is emerging. The US has established a mandatory registration system, which will have competitive elements such as equal access and other rules to ensure full disclosure, and will disclose performance statistics straight away. The European Securities Market Authority, once it is established, will also be likely to focus on issues such as comparative performance statistics which will arm investors. Investors today do not have adequate information and a central regulator is needed, using common criteria. Otherwise different entities will be rating themselves, each using their own criteria and their own statistics.

Prof. Langohr responded that there needs to be a demand for the information or the disclosure serves no purpose. The CRAs all publish the performance statistics on their website for free, and it takes some time to establish a uniform measure of these performance statistics, but this would be part of the rating process. So far self-regulation has not been properly exercised as since 1975 and the introduction of the NRSRO, ratings have been embedded in regulations. This is therefore used as a measure or even an excuse for bad investments.

Prof. Coffee stated that the subscriber based model was found not to be sustainable without government assistance and under a self-regulatory model the result was oligopoly.

* * *

Concluding the discussion, the Chairman made the following points:

- Although CRAs were not the actual cause of the crisis, their failings have highlighted the **need for reform** in the credit rating market and of the business models used.
- The credit rating market is a **natural oligopoly** and therefore increased competition is challenging.
- Increased **due diligence** is required by CRAs to ensure that the information going into the business models they use is verified and substantiated.
- A switch to a model in which the **investor plays a role** should be considered in order to reduce conflicts of interest and promote CRA independence.
- A **decrease in regulatory reliance** on ratings may be advisable.
- Current regulations in the credit rating market have not gone far enough, and there is **further work to be done** in this area.

COMPTE RENDU DE LA DISCUSSION

Par le Secrétariat

Le Président du Comité de la concurrence explique que le débat du 16 juin 2010 a lieu dans le contexte de discussions plus générales du Comité de la concurrence sur la crise financière, les infrastructures soutenant les marchés financiers et leurs implications pour la concurrence ayant éveillé un intérêt particulier.

Le Président Jenny introduit les intervenants invités à participer au débat : le Professeur John Coffee (de l'Université de Columbia), le Professeur Patricia Langohr (de l'ESSEC) et M. Karel Lannoo (Président et Directeur général du Centre pour l'étude des politiques publiques européennes). Il accueille également le Professeur Hans-Helmut Kotz, Président du Comité des marchés financiers de l'OCDE.

À l'invitation du Président Jenny, le Professeur Langohr [1] ouvre le débat en mettant en évidence les principales caractéristiques économiques du secteur des agences de notation financière (ANF) et en esquissant une définition de la notation financière. Les ANF délivrent des avis sur la capacité (et volonté) relative d'un émetteur à honorer ses engagements financiers. Ces avis se veulent (i) des notations ordinales sur une échelle alphanumérique, (ii) stables (les ANF s'efforcent de fournir une évaluation sur la durée du cycle), (iii) cohérents et comparables à travers les instruments, les échéances, les secteurs et les pays, et (iv) objectifs et transparents. La notation financière porte sur la probabilité de défaut ; elle situe un émetteur ou un instrument sur une échelle allant du risque de défaillance le plus réduit au risque de défaillance le plus élevé.

Le secteur des ANF, tel qu'on le connaît aujourd'hui, a vu le jour en 1909 avec Moody's. En 1924, le marché comptait deux autres intervenants, Fitch et S&P, mais restait concentré. Jusqu'en 1970, c'est le modèle « *investisseur-payeur* » qui a dominé. Les notations étaient utilisées à certaines fins réglementaires et la demande en était relativement stable. À partir de 1970 et jusqu'en 2001, une mutation s'est opérée en faveur du modèle « *émetteur-payeur* ». En 1975, la SEC a créé le statut NRSRO[2] et en 2000, Fitch était devenu la troisième ANF de dimension internationale. Le rôle des ANF s'est considérablement développé avec la désintermédiation financière,[3] l'institutionnalisation des investissements et l'accélération des mutations dans le secteur. À partir de 2002 et jusqu'à aujourd'hui, l'innovation financière et la mondialisation ont encore accru le rôle dévolu aux ANF. 2007 a vu la fin du numerus clausus pour le statut NRSRO. Pendant 35 ans, seuls trois ANF ont pu acquérir ce statut (certaines l'ont obtenu de façon transitoire avant de fusionner avec l'une des ANF dominantes) ; elles sont aujourd'hui onze à pouvoir se prévaloir du statut NRSRO.

1 Voir aussi "The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They are Relevant" par Herwig Langohr and Patricia Langohr, John Wiley & Sons , 2009.

2 Nationally Recognised Statistical Rating Organisation.

3 Retrait des fonds des établissements financiers en vue de les investir directement.

Les notations fondamentales remplissent trois fonctions :

- la fonction économique originelle de la notation est de *mesurer le risque de crédit* que pose l'émetteur, de façon objective, et de résoudre l'asymétrie fondamentale d'information entre émetteurs et investisseurs. Elle facilite ainsi l'accès des émetteurs aux marchés de capitaux ;

- sa deuxième fonction est de procurer un *moyen de comparaison* à travers l'ensemble des émissions de titres comportant un risque de crédit et une échelle de notation cohérente pour faciliter la construction des portefeuilles. C'est une fonction essentielle pour les investisseurs ;

- enfin, les notations procurent aux intervenants sur les marchés *une norme commune* ou un vocabulaire commun pour désigner le risque de crédit. La notation est un avis indépendant sur le crédit exprimé sous la forme d'une évaluation unique et opposable, c'est-à-dire d'une mesure observable et vérifiable par chacun et donc apte à être intégrée dans les contrats et règlements. C'est une fonction essentielle pour la prescription, c'est-à-dire pour les contrats privés, les directives d'investissement et les règlements.

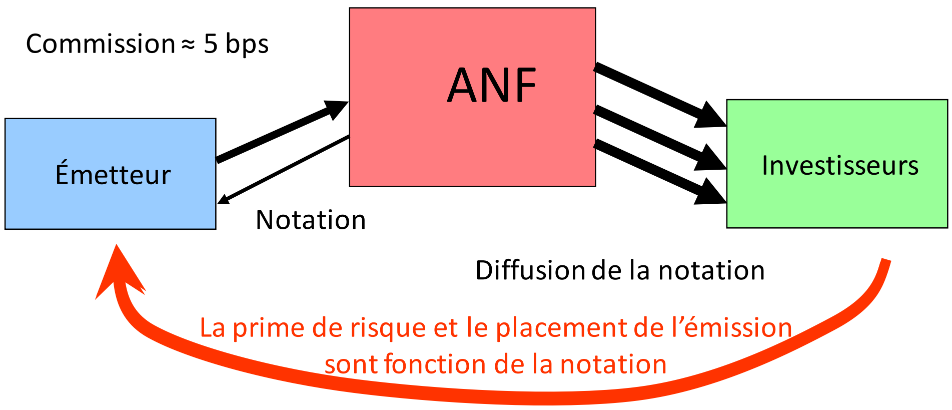
Ces trois fonctions associées apportent de la valeur au marché. Elles sont complémentaires, chacune accroissant la valeur et l'utilité des deux autres. Historiquement séparées, ces trois fonctions ont été réunies au fil du temps par l'évolution endogène des notations fondamentales. La comparabilité et l'opposabilité sont des caractéristiques qui ont des implications importantes pour la nature de l'interaction concurrentielle entre les ANF. Chacune des trois fonctions était historiquement dévolue à un agent distinct : (i) la presse professionnelle et financière décrivait la conjoncture économique et sectorielle, (ii) les agences d'évaluation du crédit évaluaient la capacité des commerçants à honorer leurs engagements financiers et (iii) les banques d'investissement jouaient leur réputation chaque fois qu'elles garantissaient une souscription.

Selon le Professeur Langohr, plusieurs facteurs clés affectent de façon intrinsèque la dynamique de la concurrence dans ce domaine. D'abord, les notations sont des produits d'expérience, c'est-à-dire qu'on n'en connaît la qualité qu'après en avoir utilisé un large échantillon. L'absence de défaut ne justifie pas à elle seule la qualité de la notation. Par conséquent, une réputation de qualité construite sur la durée constitue un avantage concurrentiel crucial. Ensuite, les investisseurs ont besoin de notations comparables et cohérentes à travers les segments et les instruments. Les notations d'une ANF procurent une norme commune pour interpréter le risque. Il n'est pas dans l'intérêt des investisseurs de mobiliser des ressources considérables pour l'interprétation de normes multiples : toutes choses égales par ailleurs, plus une ANF dispose d'un « parc » important, plus elle est précieuse pour les investisseurs. Enfin, les entreprises émettrices entretiennent une relation de confiance avec une ou plusieurs ANF, mais ne cherchent pas d'autres notations. Construire une telle relation nécessite un temps précieux au niveau de la direction générale des établissements. Les entreprises privilégient les ANF auxquelles les investisseurs accordent le plus de confiance, afin de faciliter la souscription et d'obtenir la prime de risque la plus réduite. En conséquence, du fait de ce qui précède, le marché des ANF constitue un oligopole naturel.

Le marché des notations fondamentales ne peut faire vivre qu'un nombre limité d'agences. Il est voué à demeurer un oligopole, les ANF se concurrençant *pour* le marché (tentant de s'imposer comme norme) plutôt que *sur* le marché. Toutefois, même entre un nombre réduit d'ANF, la dynamique de la concurrence peut se fonder sur l'établissement d'une réputation de qualité des évaluations. Cette discipline de marché peut aussi atténuer le conflit d'intérêt inhérent au modèle émetteur-payeur. L'accès au marché des ANF est tellement restreint que la concurrence y est différente des autres marchés. Il peut toutefois arriver qu'elles se concurrencent âprement, mais pas sur le plan de la qualité des notations, sachant qu'une issue négative les affecterait toutes, si bien qu'aucune n'encourt le risque de perdre de parts de marché.

Les ANF ont le choix entre deux modèles. Le premier fonctionne par abonnement (investisseur-payeur), les utilisateurs, investisseurs institutionnels ou courtiers, payant pour obtenir les notations. Dans le second, retenu par les trois grandes ANF, ce sont les émetteurs qui payent (cf. graphique 1). Dans ce dernier modèle, des commissions sont essentiellement facturées aux émetteurs dont les ANF notent les émissions, en dépit du fait que l'engagement premier des ANF s'exerce envers la communauté des investisseurs. Jusqu'en 1970, les ANF délivraient gracieusement leurs notations aux émetteurs et vendaient leurs publications aux investisseurs sur abonnement. Le modèle investisseur-payeur s'est cependant révélé éphémère. S'il garantissait l'indépendance des ANF vis-à-vis des émetteurs notés, il ne permettait pas de générer des revenus suffisants pour assurer leur existence, leurs publications pouvant aisément être dupliquées.

Graphique 1. Conflit d'intérêt inhérent au modèle émetteur-payeur



La récession qui a frappé les États-Unis au début des années 70 a modifié la dynamique du secteur. Les émetteurs ont accepté de payer pour obtenir une notation capable de démontrer au marché qu'ils étaient des emprunteurs solvables. La demande de notation allant croissant, les ANF se sont trouvées en mesure de facturer leurs services. Cette pratique s'est tellement développée qu'en 1987 près de 80 % du chiffre d'affaires de S&P's provenait de commissions versées par les émetteurs. Le solde était généré par la vente d'études et d'informations sur les notations aux grands investisseurs institutionnels, entreprises et bibliothèques.

Deux raisons justifient la facturation des émetteurs. D'abord, la publication de notations indépendantes leur est très profitable, puisqu'elle leur ouvre l'accès aux marchés obligataires et abaisse leur coût de financement. Ensuite, les ANF ont besoin de ces revenus pour couvrir leurs coûts d'exploitation.

Si les notations sont utiles à la fois aux émetteurs et aux investisseurs, les émetteurs sont plus enclins à payer pour les obtenir. Cela provient de ce que les notations présentent deux caractéristiques pour les investisseurs : (i) la non-excluabilité des informations relatives aux notations et (ii) la redondance de toute notation spécifique.

Le Professeur Langohr note que plusieurs facteurs perturbent la discipline de marché et l'établissement de la réputation. Le premier est l'utilisation des notations par la réglementation. La notation est tellement inscrite dans les directives et les règlements que l'appréciation de la sécurité d'un placement lui a été dévolue de fait (cf. tableau 2 quelques exemples d'utilisation des notations dans la réglementation américaine). Certains investisseurs, soumis à des règlements et directives d'investissement stricts, pourront même préférer une notation légèrement supérieure, même si elle est imprécise ou subjective. Bon nombre d'instruments financiers structurés ont été conçus à des fins d'arbitrage réglementaire et ont bénéficié de leur opacité. La discipline de marché est en outre perturbée par deux autres facteurs, qui sont la réglementation statutaire des ANF et une liquidité excessive. Il existe cependant plusieurs façons d'améliorer l'emploi des notations.

- *Il faut mettre un terme à l'utilisation explicite des notations par la réglementation :* elle leur confère force de loi, alors qu'il ne s'agit que d'opinions.
- *Il faut rétablir le lien entre les investisseurs et les ANF :* les ANF doivent être au service des investisseurs et les investisseurs doivent surveiller, voire évaluer, les ANF. Les ANF doivent améliorer leur réputation en refusant de procéder à une évaluation en l'absence d'informations suffisantes. C'est aux décisionnaires, c'est-à-dire aux investisseurs, qu'il devrait incomber de justifier de la sécurité d'un placement.
- *La réglementation devrait vérifier la production, c'est-à-dire la performance :* la surveillance des intrants créé des incitations perverses, n'aligne pas les intérêts, étouffe l'innovation et confère une impression illusoire de sécurité.

Une solution envisageable consisterait à adopter un modèle *instance-payeuse,* ce qui résoudrait le conflit émetteur-payeur, permettrait de sauvegarder l'opposabilité et pourrait stimuler la concurrence si l'autorité de réglementation qui choisit l'ANF est en mesure d'évaluer la qualité des notations et de récompenser cette sélection. Cela impliquerait toutefois de placer beaucoup de confiance dans l'autorité de réglementation et, l'instance servant de mécanisme de substitution au marché, cela reviendrait encore à lui déléguer la décision quant à la sécurité du placement. La structure d'incitation à long terme offrirait une autre solution, en vertu de laquelle les émetteurs paieraient aujourd'hui leur notation et l'ANF percevrait le paiement après coup, c'est-à-dire une fois la performance évaluée. Il est cependant délicat de jauger la performance d'une notation unique et la performance n'est pas une notion évidente. Le coût serait immédiat, mais l'avantage pourrait ne se manifester qu'à très longue échéance. Les émetteurs pourraient par conséquent être tentés d'en faire l'économie et l'incitation de performance pourrait ne pas être suffisante. On peut en outre se demander si ce modèle permettrait à un nombre suffisant d'ANF de survivre.

Tableau 2. Exemples d'utilisation des notations dans la réglementation américaine

Année	Réglementation fondée sur les notations	Notation minimum	Combien	Autorité/réglementation	Utilisation
1936	Interdire aux banques l'achat de titres spéculatifs	BBB	Non précisé	Déclarations conjointes de l'OCC, de la FDIC et de la Réserve fédérale	Réglementation prudentielle
1982	Alléger les obligations déclaratives pour les obligations à statut d'investissement	BBB	1	Adoption par la SEC d'un système intégré de déclaration	Facilitation de l'accès au marché
1984	Faciliter les émissions de titres adossés à des créances hypothécaires d'entités non gouvernementales	AA	1	Promulgation par le Congrès de la loi de 1984 relative à la promotion du marché secondaire des créances hypothécaires	Facilitation de l'accès au marché
1989	Permettre aux fonds de pension d'investir dans les titres de qualité adossés à des actifs	A	1	Département du Travail Assouplissement des restrictions ERISA	Protection des investisseurs
1991	Limiter la détention par les fonds monétaires de titres mal notés	A1*	1	Amendement du règlement 2a-7 de la SEC sous l'empire de la loi de 1940 sur les sociétés d'investissement	Protection des investisseurs
1994	Imposer aux banques et caisses d'épargnes des obligations de fonds propres réglementaires variables sur les différentes tranches des titres adossés à des actifs	AAA et BBB	1	Réserve fédérale, OCC, FDIC, OTS Proposition de règle sur les substituts directs et en recours	Obligations de fonds propres réglementaires

La présentation du Professeur Coffee traite des échecs du marché de la notation financière et des réformes à apporter aux ANF. Au bout du compte, la crise financière a révélé non seulement les insuffisances de la technologie financière, c'est-à-dire la titrisation de créances adossées à des actifs, mais également l'échec et la position conflictuelle des ANF. Il est clair que les autorités de réglementation, par laxisme, et les ANF, en raison des conflits d'intérêt qui les habitent, n'ont pas vu (ou n'ont pas voulu voir) à quel point s'était détériorée la qualité du crédit sur le marché de l'immobilier américain (cf. tableau 3).

Tableau 3. Prêts hypothécaires à risque (2001-2006): Évidence de la détérioration rapide de la qualité du crédit

	Part des prêts avec peu ou pas de justificatifs	Remboursements d'emprunts/revenus	Montant du prêt/valeur de l'actif	Part des emprunts à taux variable	Part des emprunts à remboursement différé du principal
2001	28,5 %	39,7 %	84,0 %	73,8 %	0,0 %
2002	38,6 %	40,1 %	84,4 %	80,0 %	2,3%
2003	42,8 %	40,5 %	86,1 %	80,1 %	8,6 %
2004	45,2 %	41,2 %	84,9 %	89,4 %	27,3 %
2005	50,7 %	41,8 %	83,2 %	93,3 %	37,8 %
200+6	50,8 %	42,4 %	83,4 %	91,3 %	22,8 %

Les études empiriques montrent clairement que la titrisation a conduit les émetteurs de prêts à une faible sélectivité. Il s'agit dans une certaine mesure d'un problème classique d'aléa moral, parce qu'à chaque étape, des prêts insolvables ont été soit émis, soit revendus, par des personnes qui n'escomptaient pas conserver cette exposition sur la durée. Les banques d'investissement ont racheté des prêts risqués à leurs émetteurs en sachant qu'elles seraient en mesure de les titriser à une échelle internationale, pourvu qu'elles obtiennent une notation d'un NRSRO conférant à l'opération de titrisation la qualité d'investissement. Cette pratique a été encouragée par un assouplissement des normes des ANF, pour les raisons suivantes :

- *la clientèle des ANF* - la nature de la clientèle des ANF s'est modifiée, les banques d'investissements étant moins nombreuses à présenter des opérations et menaçant de s'adresser ailleurs (cf. graphique 4) ;

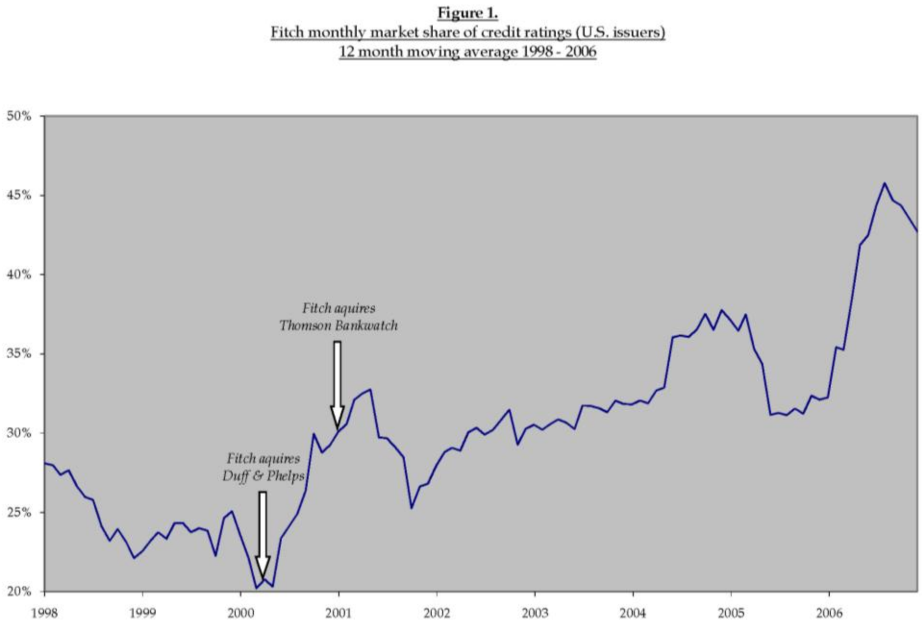
Graphique 4. Forte concentration du marché de la titrisation des créances adossées à des actifs hypothécaires en 2007

Rank	Book Runner	Number of Offerings	Market Share	Proceed Amount + Overallotment Sold in US ($mill)
1	Lehman Brothers	120	10.80%	$100,109
2	Bear Stearns & Co., Inc.	128	9.90%	$91,696
3	Morgan Stanley	92	8.20%	$75,627
4	JP Morgan	95	7.90%	$73,214
5	Credit Suisse	109	7.50%	$69,503
6	Bank of America Securities LLC	101	6.80%	$62,776
7	Deutsche Bank AG	85	6.20%	$57,337
8	Royal Bank of Scotland Group	74	5.80%	$53,352
9	Merrill Lynch	81	5.20%	$48,407
10	Goldman Sachs & Co.	60	5.10%	$47,696
11	Citigroup	95	5.00%	$46,754
12	UBS	74	4.30%	$39,832

1. Les 6 premiers distributeurs contrôlaient plus de 50 % du marché.
2. Les 12 premiers en contrôlaient plus de 80 %.

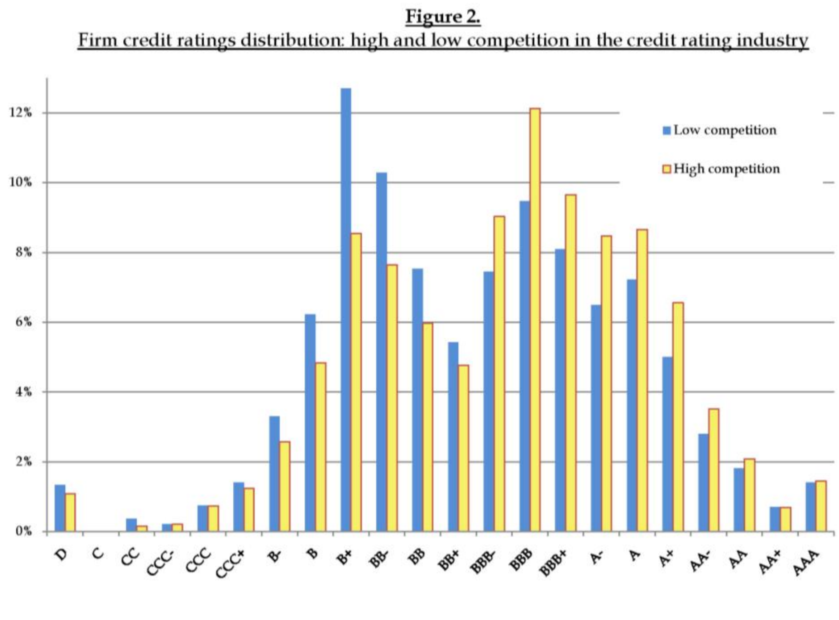
- *Fitch Ratings* - la montée en puissance de Fitch a entraîné une inflation des notations. À partir de 2004, les banques d'investissement pouvaient brandir efficacement la menace de préférer Fitch à Moody's ou S&P (cf. graphique 5).

Graphique 5. Becker et Millbourne - Réputation et concurrence



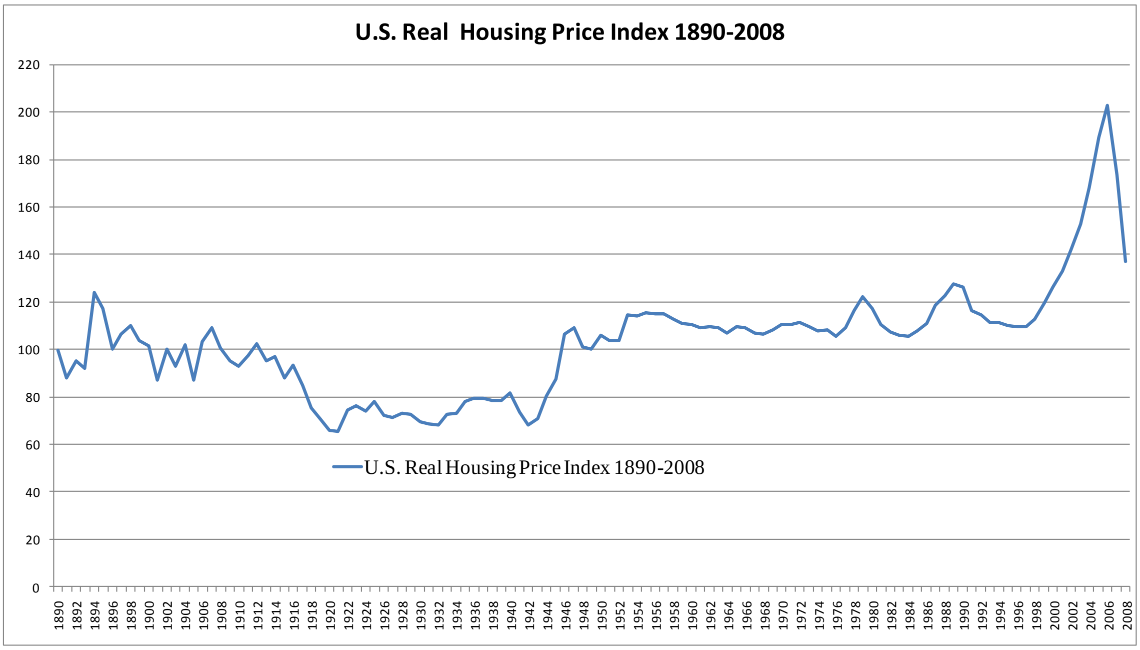
Pour de nombreux observateurs, c'est précisément de concurrence que le marché de la notation financière a besoin. Toutefois, Becker et Milbourne montrent que le surcroît de concurrence s'est en fait traduit par une inflation des notations. Le pourcentage de notations conférant la qualité d'investissement a augmenté à mesure que la concurrence s'intensifiait et celui des notations inférieures a diminué, sur l'ensemble de l'échelle de notation (cf. graphique 6) ;

Graphique 6. Inflation des notations et diminution des notations inférieures sous l'impact de la concurrence



- *le prix de l'immobilier* - les ANF ont supposé à tort que le prix de l'immobilier résidentiel ne chuterait pas, de façon générale, même si le taux de défaillance des emprunteurs augmentait (cf. graphique 7) ;

Graphique 7. La bulle de l'immobilier résidentiel aux États-Unis



- *les mesures de contrôle préalable* - comme les banques d'investissements ne voulaient pas que des informations négatives parviennent aux ANF, la vérification factuelle des éléments clés du modèle d'évaluation des ANF a diminué.

Le rapport publié par la SEC en 2008 après l'examen de certaines ANF (« *Staff's Examination of Select Credit Rating Agencies* ») indique que certaines d'entre elles « ne mettaient en place aucune mesure de contrôle préalable et ne cherchaient pas autrement à vérifier l'exactitude ou la qualité des informations relatives aux prêts immobiliers sous-jacents aux instruments qu'elles notaient. » Il y a encore peu de temps (jusqu'en 2000 à peu près), les mesures de contrôle préalable constituaient une étape du processus de notation, les arrangeurs employant des bureaux spécialisés (dont les plus connus sont Clayton Holdings et Bohan Group) pour échantillonner et tester les portefeuilles de prêts hypothécaires avant de les racheter aux établissements émetteurs. À partir de 2000, cependant, alors que la qualité des garanties du marché à risque commençait à se dégrader, les arrangeurs ont progressivement arrêté de faire appel à ces bureaux de contrôle préalable. On peut penser qu'ils espéraient ainsi soustraire à l'attention des ANF les mises en garde formulées par ces bureaux spécialisés ; bref, les arrangeurs et les ANF se sont accommodés de la détérioration de la qualité du crédit.

Certains analystes attribuent les erreurs commises par les ANF à des modèles d'évaluation défectueux. Toutefois, des indications plus récentes permettent de penser qu'elles se sont en fait systématiquement distancées de leurs modèles d'évaluation, opérant des rehaussements délibérés. Griffin et Tang ont conclu de l'étude de 916 CDO émis entre 1997 et 2007 que ces pratiques avaient eu pour effet de gonfler de 12,1 % la tranche AAA. Ils notent que « *seulement 1,4 % des CDO notés AAA émis entre 1997 et 2007 respectaient la norme de défaut publiée par l'ANF pour la notation AAA* », considèrent que « *la tranche AAA méritait en moyenne une notation BBB* » et estiment qu'au total les 916 CDO analysés étaient surévalués de 86,2 milliards d'USD. Les ANF procédaient à des ajustements dans les deux sens, mais dans 84 % des cas, il s'agissait de rehaussements.

En mai 2010, une étude de la Banque de la Réserve fédérale de New York portant sur plus de 60 000 opérations de titrisation de prêts hypothécaires réalisées entre 2001 et 2007 (soit 90 % de l'ensemble des opérations de cette période) a montré que l'ajustement des notations en fonction des risques avait considérablement diminué par rapport à 2005-2007, gonflant artificiellement la tranche AAA. L'observation la plus remarquable de cette étude est que les opérations intégrant une proportion importante de prêts avec peu de justificatifs ont un taux d'échec disproportionnellement élevé, même par comparaison avec d'autres types d'opérations à risque. On en conclut qu'en période de prospérité, on se soucie moins de protéger le capital de la réputation.

Le Professeur Coffee présente trois modèles de réforme, visant chacun à remédier aux excès du modèle émetteur-payeur :

- *soumettre le marché à l'arbitrage des pouvoirs publics* - l'amendement Franklin prévoit qu'un conseil d'évaluation des agences de notation financière sélectionne l'agence chargée de noter les financements structurés, laissant à l'émetteur la possibilité de payer pour obtenir des notations supplémentaires. Ce modèle utiliserait une loterie ou un système de rotation et le volume des notations garantirait l'absence de choix individuels. Toutefois, un système de rotation ou de loterie éliminerait toute incitation à une concurrence pour la qualité des notations. Imposer une norme de fiabilité favoriserait les trois grandes agences, car il faudrait aux nouveaux entrants une dizaine d'années (ou plus) pour réunir suffisamment de données ;
- *promouvoir un modèle sur abonnement* - exiger soit (i) que les investisseurs institutionnels obtiennent une notation auprès d'une ANF non rémunérée par l'émetteur, (ii) que les émetteurs mandatent une ANF pour une seconde notation d'une ANF « détenue par les investisseurs » (Grundfest et Hochenberg) ou (iii) que l'administration sélectionne l'ANF recommandée au terme d'un sondage ou par un vote des investisseurs. L'objectif de ce modèle serait d'inciter les ANF à se concurrencer pour obtenir la faveur des investisseurs. Il n'existe cependant qu'une seule ANF fonctionnant par abonnement aux États-Unis, ce qui permet de penser que les investisseurs institutionnels ne se pressent pas pour souscrire les abonnements. En outre, ce modèle n'élimine pas totalement les conflits, puisque certains investisseurs chercheront à rationaliser les achats de titres risqués à haut rendement. On peut par ailleurs se demander si l'arrangeur ne pourrait pas rembourser à l'investisseur les frais encourus pour les notations, si les investisseurs ne seraient pas tentés de se grouper en collectifs et si l'on doit se soucier de ce que ce modèle implique la privatisation de toutes les agences de notation ;
- *fournir un service public* - les pouvoirs publics prépareraient leurs propres notations, mais les émetteurs resteraient libres de payer pour obtenir des notations. On peut cependant craindre qu'une agence publique de notation ne défavorise une grosse société locale avec une notation spéculative (comme GM aux États-Unis ou Volkswagen en Allemagne). Des ANF devant rendre des comptes sur le plan politique pourraient être soumises à des pressions intenses. Par exemple, la réaction à un abaissement de la notation de la dette souveraine grecque mettrait-elle en évidence un réflexe de sanction du messager ? Une agence publique de notation serait-elle à même de concurrencer efficacement les analystes mieux rémunérés des ANF privées ou une ANF publique paneuropéenne serait-elle plus indiquée ?

On peut aussi se demander, dans le même ordre d'idées, s'il faudrait déréglementer les ANF et si le « pouvoir d'estampille » des trois grandes agences explique leur domination. Cette thèse se heurte aux objections suivantes : (i) la domination des trois grandes agences est antérieure de plusieurs dizaines d'années à leur pouvoir d'estampille, (ii) elles exercent également une domination en Europe et (iii) depuis la loi américaine de 2006, pratiquement tout candidat compétent peut prétendre au statut NRSRO. Pourtant, les trois grandes agences continuent de régner. On peut aussi se poser la question de savoir si une analyse de crédit maison n'est pas envisageable pour les CDO ou autres produits opaques. La problématique des marchandises publiques (risque de resquille) et l'histoire (années 70) peuvent faire redouter qu'un modèle par abonnement ne puisse fonctionner sans soutien des pouvoirs publics ou obligations légales. Il est possible que les économies d'échelle permises par la production d'informations ne conduisent naturellement à une concentration du marché des notations.

Le Professeur Coffee s'interroge : dans ce contexte, que devrait faire l'AEMF (Autorité européenne des marchés financiers) ? Le problème est que la supervision administrative d'un processus complexe et technique se réduit souvent à une procédure d'évaluation mécanique. On peut en outre douter que les autorités chargées de la réglementation soient pleinement en mesure de comprendre ou de juger les modèles d'évaluation des ANF. Pire, si elles ont ce pouvoir, elles pourraient être tentées de pénaliser les ANF qui procèderaient à des révisions en baisse au mépris de toutes considérations politiques.

Par conséquent, il convient en priorité (sur la base des données de Griffin et Tang) d'établir une surveillance des notations délibérément supérieures aux recommandations des propres modèles d'évaluation des ANF. Le règlement 17g-2 de la SEC (adopté en 2009) exige désormais d'un NRSRO qu'il justifie les raisons de tout écart significatif par rapport à son modèle d'évaluation quantitatif. Figurent au rang des autres réformes utiles : (i) l'obligation d'insérer dans les contrats une commission pluriannuelle de surveillance des notations de façon à inciter les ANF à actualiser ou abaisser leurs notations, (ii) une règle d'égalité d'accès pour renforcer la concurrence en s'assurant que toute information fournie à une ANF le soit également à toutes les autres ANF qualifiées, (iii) une réglementation encourageant l'utilisation de bureaux indépendants de contrôle préalable pour réaliser des vérifications factuelles et (iv) l'interdiction pour les émetteurs de procéder eux-mêmes à leur notation ou de choisir l'agence a priori la plus favorable.

En préambule à son exposé sur la réglementation financière, M. Lannoo souligne que le débat sur le rôle des ANF est en fait antérieur à la crise. Dans le sillage de la crise de 1997 en Asie du Sud-est et de l'éclatement de la bulle des « dot com », en 2001, la réaction tardive des ANF face à la situation des finances publiques des pays affectés avait été vivement critiquée. L'exposé de M. Lannoo couvre quatre aspects : (i) les ANF aujourd'hui, (ii) le marché européen des ANF, (iii) le Règlement de l'UE sur les agences de notation de crédit et (iv) les débats de réglementation qui se recoupent.

(i) les ANF aujourd'hui

Le secteur de la notation financière est un marché mondial, toutefois contrôlé par une poignée d'intervenants. Deux d'origine américaine (Moody's et Standard & Poor's) contrôlent plus de 80 % du marché. Le troisième entrant, Fitch, est en principe européen, puisque sa société mère a son siège à Paris. Avec Fitch, les trois premiers intervenants contrôlent plus de 94 % du marché mondial. Depuis 2007, ces trois groupes ont vu leur chiffre d'affaires et leur rentabilité chuter considérablement. C'est cependant Fitch qui a été le plus affecté, ce qui permet de penser que la concurrence n'est peut-être pas le remède le plus approprié pour améliorer le statut du marché. Contrairement au modèle européen dans lequel les banques jouent le rôle moteur, les États-Unis utilisent un modèle animé par les marchés de capitaux et un système de fonctionnement composé de strates multiples. Dans la mesure où les marchés de capitaux sont restés peu développés en Europe jusque récemment, les banques se sont essentiellement chargées de l'analyse des risques de crédit. Peut-être à cause de l'excellente réputation du modèle américain dévolu aux marchés de capitaux, la fonction d'analyse des risques de crédit a décliné au sein des banques européennes, créant un marché captif pour une activité essentiellement basée aux États-Unis.

(ii) le marché européen des ANF

Deux instances de la réglementation ont conféré aux ANF un marché captif dans l'UE : (i) Bâle II, application de la directive sur les Fonds propres réglementaires (CRD) en Europe et (ii) les opérations d'apport de liquidité de la BCE. Toutes deux utilisent de façon explicite le barème de notation des ANF pour déterminer la pondération des risques à appliquer pour le calcul des exigences de fonds propres, dans un cas, et pour celui des seuils et décotes, dans l'autre, pour les opérations d'apport de liquidité. Aucune de ces utilisations n'existe aux États-Unis, qui n'ont pas appliqué Bâle II et le guichet d'escompte de la Fed n'étant pas basé sur les notations.

Dans le cadre de l'approche Bâle II, la pondération des risques se fonde sur les évaluations des ANF et les banques sont tenues d'affecter une partie de leurs fonds propres à la couverture des pertes potentielles. Le montant des exigences de fonds propres augmente à mesure que baisse la notation, passant de 0 % pour les emprunts d'État notés AA à 20 % au minimum pour les créances des banques et les crédits d'entreprises et jusqu'à 150 % pour les notations CCC ou inférieures. Toutefois, en application de la CRD, la pondération est de 0 % pour l'ensemble des emprunts souverains de l'EEE libellés en monnaie nationale. Une pondération des risques nulle signifie qu'une banque n'est pas tenue de mobiliser des fonds propres pour ces actifs. On peut cependant opposer que Bâle II crée un marché artificiel pour les ANF.

Comme il n'existait aucune réglementation de l'UE au moment de l'adoption de la directive, le Comité européen des contrôleurs bancaires (CECB) a adopté en janvier 2006 des « orientations relatives à la reconnaissance des organismes externes d'évaluation du crédit ». Ces orientations fixent les critères de transposition des évaluations externes du crédit en pondération des risques conformément à la CRD. L'acceptation d'un organisme de notation pour les besoins de la directive incombe en conséquence à l'autorité nationale de contrôle. Deux approches coexistent donc : l'approche Bâle II de la CRD et l'approche de liquidité de la BCE. Toutefois, le recours aux ANF est peut-être encore plus courant pour les actifs cessibles utilisés en garantie dans le cadre des opérations d'apport de liquidité de la BCE. L'évaluation du crédit des actifs acceptés en garantie se fonde principalement sur une notation publiée, émise par un Organisme externe d'évaluation du crédit (OEEC). C'est sur cette base que la BCE décide de la recevabilité des titres et du montant de la décote à appliquer.

(iii) le Règlement de l'UE sur les agences de notation de crédit

Avant l'entrée en vigueur de la réglementation de l'UE applicable aux ANF[4], la Commission européenne avait requis du Comité européen des régulateurs des marchés de valeurs mobilières (CERVM) un avis technique sur les pratiques de marchés et les problèmes de concurrence concernant les ANF. Le CERVM a conclu que les ANF se conformaient, dans une large mesure, au code OICV[5], mais que la situation oligopolistique du secteur, le traitement des informations confidentielles, le rôle des services annexes et les notations non sollicitées continuaient de susciter des préoccupations. Le règlement de l'UE, entré en vigueur 20 jours après sa publication au Journal officiel le 7 décembre 2009, (i) stipule que les ANF doivent être enregistrées et soumises à un contrôle permanent, (ii) définit l'activité d'émission de notations de crédit, (iii) édicte des règles de gouvernance plus contraignantes, pour les opérations (compensation, par exemple) et les conflits d'intérêt, et (iv) impose aux ANF de divulguer les méthodologies, modèles et hypothèses qu'elles utilisent pour leurs notations.

La réglementation innove en confiant au CERVM un rôle central de conseil en ce qui concerne l'obligation à laquelle une ANF est soumise d'être enregistrée dans un État membre et d'en informer tous les autres États membres. L'État membre d'origine et les États membres d'accueil de l'ANF sont tenus de former un collège et de procéder ensemble à l'examen des demandes d'enregistrement et à la surveillance courante. Les États membres d'accueil ne sont pas uniquement ceux dans lesquels une ANF a une succursale, mais aussi ceux dans lesquels l'utilisation des notations de crédit est répandue ou a une incidence importante. Dans la mesure où les intervenants du secteur sont essentiellement d'origine américaine, le régime des pays tiers a été l'un des points centraux du débat. Le règlement prévoit que les

4 Règlement 1060/2009 du 16 septembre 2009, JO du 17.11.2009.

5 Organisation internationale des commissions de valeurs.

ANF établies dans un pays tiers peuvent demander une certification, à condition d'être enregistrées et soumises à une surveillance de leur pays d'origine et que la Commission ait adopté une décision d'équivalence. Toutefois, les agences de notation de crédit enregistrées dans un pays tiers ne peuvent être utilisées que si elles ne présentent pas une importance systémique pour la stabilité financière de l'UE, ce qui signifie que les grandes ANC doivent procéder à un enregistrement complet dans l'UE. En outre, les notations de crédit produites hors de l'UE doivent être avalisées par l'ANF enregistrée dans l'UE.

On a opposé que ce régime pourrait fragmenter indûment les marchés financiers mondiaux. Les entreprises étrangères seront moins enclines à lever des fonds dans l'UE, car elles auront besoin que leur notation soit avalisée localement, ce qui est nécessaire aux banques à des fins réglementaires. Les établissements financiers de l'UE investiront moins à l'étranger, car les notations d'investissements de pays tiers pourront être perçues comme de moindre qualité. Ce régime pourrait par ailleurs être qualifié d'anticoncurrentiel, car une petite ANF non implantée dans l'UE, comme c'est le cas de deux des plus grandes ANF en Asie, pourrait arrêter de noter les souverains et émetteurs de l'UE. Il pourrait être trop coûteux de s'implanter dans l'UE et la base de clientèle pour ces notations diminuerait en conséquence, puisqu'elles ne pourraient plus être utilisées par les banques européennes.

(iv) les débats de réglementation qui se recoupent

Le règlement de l'UE ne change rien au problème fondamental que posent les ANF dans une perspective d'action des pouvoirs publics, à savoir, (i) le caractère oligopolistique du secteur, (ii) le conflit d'intérêt inhérent au principe émetteur-payeur et (iii) le statut de marchandise publique de la notation privée. L'approche de l'UE apparaît comme un pis aller. Il est nécessaire de procéder à une évaluation plus fondamentale du modèle d'entreprise des ANF, en s'inspirant peut-être des modèles d'autres secteurs. Quatre solutions sont envisageables, à savoir :

- *le modèle investisseur-payeur* - les notations seraient facturées aux investisseurs. Ceux-ci et les ANF auraient un accès libre et complet à toutes les informations concernant les portefeuilles sous-jacents des titres de dette structurée ;

- *le modèle instance-payeuse* - il s'agirait en quelque sorte d'une chambre de compensation des notations, complétée par une surveillance prudentielle de la qualité des notations afin d'éviter les pots de vin ;

- *une rémunération en fonction des résultats* - ce modèle inspiré du débat sur les rémunérations variables consisterait à fonder une partie de la rémunération des analystes des ANF sur les résultats, la performance des titres notés servant d'indicateur pour le montant que les ANF pourront facturer ;

- *une structure de partenariat* - ce modèle fonctionnerait de la même façon que dans le secteur de l'audit, qui est régi par une directive de l'UE qui fixe des règles strictes de gouvernance et de contrôle de la qualité, et limite la part des services hors audit qu'un cabinet d'audit est autorisé à fournir à un client d'audit.

M. Lannoo conclut qu'il convient d'approfondir l'analyse des mécanismes sous-jacents du marché de la notation financière, car la législation adoptée par l'UE ne résout pas les problèmes fondamentaux du secteur. Elle génère à la place des effets secondaires, dont le plus important est l'estampille de l'autorité contrôle. Un aspect positif de la réglementation de l'UE est la possibilité ouverte à la DG Concurrence d'œuvrer davantage dans ce domaine. Cependant, compte tenu de la gravité de la crise financière et du rôle central des agents de notation, une réforme de plus grande envergure est nécessaire, dans l'UE en tout cas, dans le sens du modèle instance-payeuse ou d'une structure incitative à long terme.

Le Professeur Kotz réitère la remarque de M. Lannoo quant au fait que le débat sur la capacité des ANF à apprécier correctement le niveau des risques de défaillance a commencé il y a dix ans (plus précisément en 1998, dans le sillage de la crise asiatique, et en 2001, après les scandales comptables aux États-Unis et en Europe). Ces échecs sont inévitables compte tenu de la capacité limitée à mesurer précisément les problèmes futurs du point de vue de la capacité et de la volonté de paiement des créanciers. Les ANF servent souvent de boucs émissaires, mais en même temps si des substituts fonctionnels (pour détecter les problèmes de crédit) comme les banques, les primes de risque sur les taux d'intérêt ou sur les contrats d'échange sur le risque de défaillance, ou les modèles structurels de mesure de la distance au défaut (du type du modèle de Merton) peuvent détecter les problèmes légèrement plus rapidement, ils ne sont pas beaucoup plus efficaces. Compte tenu de cette incapacité systémique, les pouvoirs publics devraient par conséquent être beaucoup plus prudents lorsqu'ils se fient aux ANF et lorsqu'ils font référence à leurs opinions dans les règles et réglementations. Ces références reviennent essentiellement à conférer aux ANF un pouvoir de certification (estampille). M. Kotz fait sien le point de vue du Professeur Coffee selon lequel la structure du secteur conduit naturellement à un oligopole étroit. Il n'y aurait par conséquent aucun bienfait à multiplier les ANF car cela induirait une réduction de la valeur des informations pour les investisseurs et donc une perte de la fonction centrale des agences de notation. S'agissant des mesures correctrices, deux difficultés ont été soulignées : l'importance (i) de la transparence, c'est-à-dire de supprimer l'opacité et de contrôler les contrôleurs, et (ii) de la diversification, c'est-à-dire d'utiliser davantage de mécanismes d'évaluation plutôt qu'une seule opinion, exclusivement. M. Kotz souligne en outre que si certains commentateurs avaient mis en avant la possibilité d'un risque systémique sur les dérivés de crédit ex ante, ce point de vue était resté très minoritaire et avait été souvent ridiculisé. Bien-sûr, au bout du compte, on s'est aperçu que c'est le consensus qui avait tort. Il a toutefois fallu un temps considérable avant que l'on accepte de reconnaître l'étendue de la crise et pendant ce temps les pouvoirs publics ont souvent pratiqué la politique de l'autruche. Ce déroulement montre l'importance de reconnaître les points de vue et avis dissidents dans la formulation de l'action des pouvoirs publics. Il conviendrait dorénavant dans la formulation de l'action des pouvoirs publics, de faire référence aux ANF moins souvent et avec la prudence qui s'impose. M. Kotz souligne par ailleurs que cette question met en évidence l'utilité d'une collaboration efficace entre le Comité des marchés financiers et le Comité de la concurrence de l'OCDE pour soutenir les points de vue étayés et les intégrer dans le débat public.

M. Blundell-Wignall, Directeur adjoint de la DAF, dénombre en résumé trois points consensuels : (i) il existe un problème, (ii) il existe un mécontentement à propos de l'action des autorités de contrôle en terme de réformes et (iii) il est nécessaire d'impliquer les investisseurs dans le processus de contrôle préalable, peut-être par le biais d'un modèle investisseur-payeur. L'intervention de M. Blundell-Wignall porte sur trois aspects liés à ces questions :

- *les abus* - il y a clairement abus lorsque (i) les notations de crédit créent une agitation sur les marchés, c'est-à-dire quand, dans un contexte de marché relativement calme, une rétrogradation a un impact disproportionné (cela a été clairement le cas pour les emprunts d'État grecs et cela montre que l'information n'est pas traitée de façon suffisamment claire et cohérente), (ii) il y a une asymétrie de marché, c'est-à-dire que les effets favorables d'un rehaussement ou d'une hausse sont nettement moindres que les effets négatifs d'un déclassement, et (iii) il existe un problème lié à l'interaction entre les autorités de contrôle et les autorité de la concurrence et la nature procyclique des notations. Une rétrogradation a des effets importants sur la liquidité de marché, ce qui contribue aux fluctuations de prix. Toutefois, les notations tendent à induire un retard, ce qui signifie que le cours des actions est un meilleur estimateur de ce qui arrive à une entreprise ou à un produit structuré ;

- *la structure du marché* - les abus semblent liés à la structure du marché, qui est typiquement oligopolistique. Les autres obstacles à l'entrée qui n'ont pas encore été évoqués sont (i) des réglementations qui créent un problème d'estampille qui avantage les intervenants en place, (ii) les mandats des fonds de pension qui requiert de n'investir que dans des produits financiers d'un certain niveau et (iii) les clauses des conventions de prêt qui n'autorisent d'apporter en garantie que des titres d'un certain niveau de crédit. Ces trois obstacles sont peut-être plus importants que celui de la « réputation », d'autant qu'ont a pu vérifier la qualité déplorable des notations et recommandations. La raison pour laquelle la structure du marché pose problème peut être attribuée à l'explosion du levier des banques d'investissement intervenue en 2004. Cette évolution était liée à certaines modifications de la réglementation en dehors du cadre des ANF et plus particulièrement à la décision de la SCC de contrôler les banques d'investissement en tant qu'entités consolidées, ce qui a permis l'explosion des leviers du secteur. Cette explosion a stimulé le marché des contrats d'échange sur les risques de défaillance, les titrisations, etc. En outre, l'abaissement des exigences de fonds propres réglementaires pour les banques a aussi contribué à l'accroissement du levier. Le marché a par conséquent dû faire face à une explosion de revenus potentiels en dehors du cadre traditionnel d'intervention des ANF. Dans le contexte d'une explosion du marché dans son ensemble et des efforts déployés pour conserver les parts de marché, la structure oligopolistique a conduit à une inflation des notations des ANF dans leur course aux mandats pour noter les nouveaux produits des banques. La structure du marché a donc été l'une des roues de la machine et a contribué à l'échec du processus de notation financière ;

- *la réforme* - quel que soit le modèle utilisé, si ce qui entre n'est pas de bonne qualité, ce qui sortira ne le sera pas non plus. Les modèles fonctionnent à partir d'informations protégées, sans aucune obligation d'analyse fondamentale ou de vérification et de justification des informations de départ. On peut comparer l'infrastructure de ces modèles à un réseau à haut débit, c'est-à-dire que le problème central est celui de l'accès au réseau et que la concurrence devrait s'opérer sur le contenu et non sur l'accès à un certain modèle. Il faudrait par conséquent que les modèles soient en libre accès et gratuits, ou d'un coût réduit, et que la concurrence s'établisse au niveau de ce qui y entre plutôt que de l'accès aux modèles eux-mêmes. En plus d'ouvrir ces modèles, il faudrait également trouver un moyen d'accéder aux énormes quantités d'informations détenues par les courtiers, tant sur les actions que sur les produits obligataires. Cela permettrait l'émergence d'un point de vue différent, en plus d'introduire une concurrence contre les ANF.

En résumé, il faudrait accueillir favorablement les réformes du modèle émetteur-payeur, en plus d'un étalement des commissions sur la durée, d'une transparence des notations, de leur historique et de leur performance, d'une interdiction des conflits d'intérêt et d'encourager la concurrence sur le contenu. Enfin, il faudrait souligner que les ANF n'ont pas été à l'origine de la crise, car des pays comme l'Australie, le Canada et le Brésil, qui utilisent tous les mêmes ANF, n'ont pas été affectés par la crise financière. Les faits plaident toutefois pour une coopération beaucoup plus étroite entre les autorités de la concurrence, les autorités de contrôle et les marchés de valeurs mobilières. Jusqu'ici, ces institutions ont fonctionné dans des univers distincts, alors qu'elles ont un fort effet d'interaction et devraient travailler ensemble.

Un délégué de l'Italie se réjouit de la qualité de la discussion, qui l'a beaucoup intéressé, et pose deux questions. D'abord, tout en appuyant la suggestion de faire payer les investisseurs, nous sommes tous des investisseurs, donc qui, exactement, doit payer ? On a comparé les ANF au secteur de l'audit. Qu'est-ce qui justifie d'opérer une distinction ? Les commissaires aux comptes sont rémunérés par l'entreprise qu'ils auditent et non par l'investisseur. En outre, les auditeurs sont parvenus à éliminer les conflits d'intérêt auxquels sont confrontés les ANF. Pourquoi conviendrait-il de traiter différemment le domaine de la notation financière ? Ensuite, on a évoqué le rapport du Professeur Coffee devant le sénat des États-Unis, l'année dernière, dans lequel il a déclaré que la responsabilité des ANF ne les exposait pas à des amendes ou à des sanctions, c'est-à-dire qu'elles n'avaient pas à répondre devant les tribunaux de leurs déclarations. Or, dans le secteur de l'audit, la responsabilité est associée à l'escroquerie et non à une erreur d'évaluation. En conséquence, qu'aurait-on dû leur reprocher si les ANF avaient été juridiquement responsables ? Pourrait-on les traduire en justice pour ce qu'elles ont fait, si leur responsabilité pouvait être invoquée devant les tribunaux ?

Le Professeur Coffee répond que les ANF et les cabinets d'audit sont tous deux des garde-fous de la finance responsables vis-à-vis des investisseurs, mais rémunérés par les émetteurs. Ils se différencient cependant en ceci que les cabinets d'audit sont soumis à une responsabilité financière depuis longtemps et il est bien établi qu'un pourcentage de leur chiffre d'affaires global est alloué au règlement des litiges ou à leur défense. Les cabinets d'audit sont ainsi incités à ne pas prendre de risques dans leurs jugements, ni à se plier exagérément aux préférences des émetteurs. Aux États-Unis, ils sont responsables en cas d'escroquerie, mais de simple négligence, tout du moins du point de vue des lois fédérales sur les valeurs mobilières. Toutefois, la chambre des représentants et le sénat débattent actuellement de deux projets de lois, bien qu'aucun accord n'ait encore été trouvé. En vertu du projet de loi examiné par la chambre des représentants, la responsabilité des ANF ne serait mise en cause qu'en cas de négligence grave. Le projet du sénat (rédigé par le Professeur Coffee) s'en tient au critère de l'escroquerie et l'affaire irait devant les tribunaux et ne pourrait être classée avant jugement en cas d'accusations détaillées de vérifications insuffisantes et d'absence d'investigation raisonnable. Cela créerait une forte incitation légale à réaliser des vérifications suffisantes ou à charger un cabinet tiers du contrôle préalable. La particularité des ANF, c'est qu'elles ne procèdent actuellement à aucune vérification factuelle et cela appelle une réforme.

Un délégué de la Commission européenne (ci-après la « Commission ») introduit son intervention en soulignant qu'un marché oligopolistique ne pose pas nécessairement un problème de concurrence. Comme les intervenants l'on montré, les occurrences de concurrence sur ce marché ont en fait conduit à une inflation des notations, ce qui indique que la concurrence n'est pas la véritable nature du problème. Dans son analyse du marché, la Commission n'a pas trouvé d'infractions à la concurrence et les problèmes concernent davantage le domaine de la réglementation que celui de la concurrence. Le délégué souligne deux points essentiels. D'abord sous l'empire de la réglementation existante, adoptée l'année dernière et décrite par M. Lannoo, les ANF seront enregistrées à compter de septembre 2010. Cette réglementation créera une obligation de transparence sur les méthodologies et les modèles, outre la conservation et le dépôt central des notations, et l'obligation de se doter de mécanismes internes de contrôle de la qualité.

Ensuite, une nouvelle proposition qui date du début du mois de juin concerne la création d'une autorité de contrôle européenne qui aurait des pouvoirs similaires à ceux d'une autorité de la concurrence. L'autorité de contrôle disposerait ainsi de pouvoirs d'investigation importants, outre le pouvoir de proposer à la Commission l'imposition de sanctions ou d'amendes. Toutefois, ces pouvoirs se cantonneraient au contrôle et la DG Concurrence conserverait tous pouvoirs sur les aspects de concurrence. Un élément intéressant du point de vue de la concurrence est la règle d'égalité d'accès pour les produits financiers structurés dont a parlé le Professeur Coffee. Cette règle contraindrait les émetteurs à permettre aux ANF concurrentes notant ces produits d'avoir librement accès aux informations transmises.

Les travaux sur les ANF se poursuivent et la Commission a annoncé qu'elle envisageait l'éventualité d'une agence de notation européenne, qui aurait la même structure que le modèle de service public décrit par le Professeur Coffee, ou bien de charger des entités publiques indépendantes de réaliser les notations. La notation des dettes souveraines sera également examinée et les réflexions se poursuivront sur le volant actuel d'emprunts de référence ou d'alternatives de substitution. S'agissant des cours de bourse, cela est lié à la question du contrôle préalable indépendant et la réflexion doit se poursuivre dans ce domaine. Une évaluation de la directive fonds propres réglementaires, qui prévoit l'utilisation des notations pour la pondération des actifs en fonction de leur risque, est également prévue prochainement. La Commission va par conséquent traiter dans les mois ou les années qui viennent de nombreuses questions abordées aujourd'hui.

Un délégué de l'Égypte fait référence à une récente décision en vertu de laquelle une entreprise peut utiliser un cabinet d'audit pendant une période de trois ans, mais, au-delà, doit faire appel à un autre cabinet. On garantit ainsi que les commissaires aux comptes ne restent pas suffisamment longtemps avec la même entreprise pour s'immiscer dans le processus de prise de décision. Le délégué appuie l'idée d'un enregistrement des ANF en Europe. La plupart des ANF passent peu de temps à visiter une entreprise, quelques semaines, par exemple, s'entretiennent avec quelques personnes et fondent leurs hypothèses et leurs décisions de notation pour l'ensemble de l'année suivante sur ces entretiens rapides. Cette mauvaise gestion ou l'insuffisance des informations ont été évidentes dans la crise asiatique. Les banques centrales et les pouvoirs publics ont également un rôle important à jouer dans ce domaine et le problème des prêts immobiliers aux États-Unis trouve son origine dans le comportement autodestructeur des banques. Plus elles émettaient de prêts sans justificatifs, garanties ou remboursements, plus il y avait de demande de prêts immobiliers, jusqu'à ce que le marché soit totalement saturé et qu'il n'y ait plus de demande nouvelle de nouveaux emprunts. Il aurait par conséquent fallu imposer des restrictions, pour s'assurer que les remboursements ne dépassent jamais 35 % des revenus de l'emprunteur. Dans certains cas, des prêts ont été émis dont les remboursements représentaient la moitié des revenus de l'emprunteur augmentés des frais financiers. Les banques ont également été confrontées à des restrictions, les forçant à prêter à un seul secteur de l'économie plus qu'un certain pourcentage de leurs dépôts ou de leur base d'actifs, pour de ne pas être exposées à un seul segment. Ce phénomène a été évident dans la banque d'entreprise et d'investissement. Les établissements davantage implantés dans la banque d'entreprise ont mieux résisté que ceux où prédominait la banque d'investissement. Le problème de la banque d'investissement, c'est que les rémunérations variables sont fondées sur les opérations et que les opérations s'achètent et se vendent quand le risque de crédit est toujours présent. Toutefois, les rémunérations variables sont versées dès le départ et les banques ne sont pas responsables des transactions, puisque celles-ci ne figurent plus dans leur bilan ou dans leurs livres.

Un délégué du Portugal pose en synthèse la question de savoir pourquoi il faudrait intervenir. Il fait remarquer que les ANF fournissent un service utile de traitement des informations sur les entreprises et les instruments financiers de telle sorte qu'elles abaissent les coûts de transaction encourus par les personnes qui souhaitent utiliser ces instruments ou investir. La question concerne par conséquent la production des ANF. Elles délivrent un avis fondé sur l'ensemble des données disponibles. En général, ces données sont accessibles au grand public, mais certaines ne sont connues que des banquiers et des contrôleurs. Le délégué se demande si nous n'exigeons pas trop des ANF quand nous leur demandons de toujours avoir raison et de ne pas commettre d'erreurs, car il est évident que les plus grosses erreurs se produisent lorsque se forme une bulle. Il est très difficile de détecter une bulle à un stade précoce et il est par conséquent irréaliste de demander aux ANF de dépister tous les problèmes. En outre, mettre en place des notations financières officielles pourrait aggraver le problème car les gens se fieront de plus en plus à ces notations officielles, en proie également à des erreurs de politique économique, à l'instar des banques centrales et des ministres des Finances.

En réponse aux questions soulevées, le Professeur Langohr souligne qu'il existe des notations financières fondées sur des informations de marché et qu'il a été démontré que ces notations sont souvent beaucoup plus aptes à prédire les défaillances que les notations financières fournies par les ANF sur les fondamentaux. Elles jouent cependant des rôles complémentaires. Les ANF détiennent des informations privées, car de nombreuses entreprises émettrices entretiennent des relations avec les ANF. Cela permet aux ANF de mesurer (i) leur volonté de payer, (ii) la stratégie future de l'entreprise et (iii) les facteurs de risque, qui sont tous des aspects qui ne peuvent pas facilement être rendus publics. Si l'on rendait le modèle transparent, les ANF n'existeraient pas car il n'existe pas de correspondance biunivoque entre l'information disponible et la notation unique. En essence, il s'agit d'essayer de prédire l'avenir et le rôle des ANF consiste à prendre position sur le sujet à un moment t. Les ANF et les informations de marché devraient par conséquent coexister, mais il est important de souligner qu'elles sont complémentaires et non substituables.

Le Professeur Coffee remarque que les questions s'articulent autour de deux thèmes : (i) l'apport des ANF est-il précieux ou sont elles un organisme superflu créé par les pouvoirs publics et qui existent du fait de leur pouvoir d'estampille et (ii) il arrive qu'il se crée des bulles sur des actifs et nous ne devons pas chercher des boucs émissaires pour des événements qui se produiront inévitablement de temps à autre. Pour ce qui est du premier de ces thèmes, l'on dispose d'une littérature empirique abondante sur la valeur ajoutée produite par les ANF. Il est possible que les contrats d'échange sur le risque de défaillance, les marchés obligataires et les marchés actions fournissent des informations précieuses, mais les recherches montrent que les notations financières apportent des informations supplémentaires qui ne sont pas contenues dans les données que fournissent les contrats d'échange sur le risque de défaillance ou les rendements obligataires. C'est pourquoi elles recèlent une certaine valeur et l'on aurait tort de supposer qu'elles finiront par disparaître ou qu'il faudrait les supprimer. S'agissant de l'argument de la bulle sur les actifs, cet aspect est particulièrement apparent aux États-Unis où de nombreux intervenants ont gagné des milliards de dollars en pariant contre le marché des titres adossés à des créances hypothécaires à partir de 2005 et 2006. Il a fallu deux ou trois années pour que la bulle éclate, ceux qui étaient motivés pour conduire leur propre enquête indépendante ont découvert la vérité et se sont fortement enrichis. Il était donc possible de connaître la vérité pour ceux qui la cherchaient, mais l'inflation des notations a permis aux établissements éloignés ou moins sophistiqués de ne pas percevoir la baisse de qualité des actifs donnés en garantie. Par conséquent, les conflits d'intérêt ont déformé la valeur de l'ANF. En résumé, les contrôleurs devraient se doter de normes indépendantes de solidité financière et ne pas se reposer sur les agences de notation à des fins de réglementation. Du point de vue du marché tel qu'il se présente aux investisseurs, il existe une demande et un besoin de notations financières, pour diverses raisons. Un modèle instance-payeuse ou sur abonnement, c'est-à-dire un système où les ANF seraient contraintes de rivaliser auprès des investisseurs plutôt que des émetteurs, servirait mieux leurs intérêts. Si la motivation est là, la réglementation peut se faire beaucoup plus discrète. Si les incitations vont dans le mauvais sens, il est possible que la réglementation demeure toujours insuffisante, quel qu'en soit le niveau, et c'est pourquoi il convient de cibler un modèle par abonnement ou d'instance-payeuse.

M. Kotz répond en quatre points : (i) l'observation tend à démontrer que les ANF ne produisent pas de meilleurs résultats que d'autres substituts et c'est pourquoi les autorités de contrôle doivent être prudentes lorsqu'elles se reposent sur elles, (ii) les résultats des ANF peuvent, en règle générale, être reproduits avec des informations disponibles dans le public, en conséquence la valeur ajoutée de leurs évaluations n'est pas impressionnante outre mesure, (iii) l'UE, avec ses initiatives pour parvenir à la transparence des méthodes et résultats d'évaluation, s'est engagée sur la bonne voie, mais peut-être aurait-il fallu intervenir davantage il y a six ou sept ans lorsque les mêmes propositions avaient été présentées et (iv) la crise n'est pas simplement affectée par l'évaluation financière et la dimension macroprudentielle ou systémique est, bien entendu, essentielle.

M. Lannoo fait brièvement part de ses réserves concernant la question du financement d'une agence publique européenne. Ce modèle ne fonctionnerait que si une structure extrêmement solide était instituée, par exemple, celle de la Banque centrale européenne (BCE), pour garantir son indépendance. Toutefois, comme le soutien financier de la BCE aux pays du sud de l'Europe, même ce modèle ne constitue pas vraiment une option praticable. Au sujet de la question de l'enregistrement, il est utile de disposer d'une homologation officielle sous la forme d'un enregistrement dans l'UE, mais on peut se demander si toutes ces réglementations peuvent aboutir au niveau européen et si les contrôleurs pourront faire face à la somme de travail que cela représente. Dans le sillage de la crise, il est donc crucial de garantir le maintien des mécanismes et de la discipline de marché, mais en même temps, sans surcharger les autorités de contrôle.

Un délégué de l'Australie s'exprime à propos des conflits d'intérêt et des incitations divergentes entre les ANF et les utilisateurs de leurs services, les investisseurs, et du fait qu'il semble que des décisions aient été prises en connaissance de cause de passer outre les conclusions de modèles spécifiques qui étaient employés. Mais quelles en sont les conséquences et quel rôle pour les investisseurs dans ce contexte ? Les investisseurs ont besoin de notations, ils doivent donc continuer à se fier aux ANF. Par ailleurs, puisqu'il existe peu d'ANF sur le marché, la possibilité réelle pour les investisseurs d'opérer un arbitrage entre les notations, qui pourrait être perçu comme une forme de sanction au sein du marché, apparaît excessivement limitée. Le délégué demande au groupe de discussion si, de son point de vue, la concurrence devrait jouer un rôle plus important sur ce marché pour que les investisseurs disposent de davantage de choix, soit au niveau de l'ANF qu'ils souhaitent utiliser, soit en complément d'un renforcement de la réglementation.

Le Président renvoie à la question liée du Professeur Langohr et lui demande de préciser si le modèle des investisseurs pourrait générer pour les agences de notation le même type d'information aujourd'hui disponible et sinon, si le modèle investisseur comporte des erreurs ou défauts qui modifieraient la performance des ANF.

Le Professeur Langohr répond que le rôle des investisseurs est crucial pour améliorer la qualité des notations et qu'il conviendrait de faire surveiller les ANF par les investisseurs plutôt que par une autorité de contrôle. Les ANF et les OICV disposent de codes de conduite et les associations d'investisseurs comme la SIFMA (*Securities Industries and Financial Markets Association*) devraient noter les ANF sur les différentes dimensions des codes. Historiquement, il a existé un code de bonne conduite des agences de notation que les ANF étaient tenues d'observer sous peine d'expliquer pourquoi elles s'en écartaient. Toutefois, plutôt que de faire appliquer la divulgation volontaire, les investisseurs devraient évaluer les ANF et faire connaître leur opinion sur leur efficacité dans chaque domaine réellement important et qui apporte aux investisseurs une valeur ajoutée. Cela forcerait peut-être les ANF à fournir de nouveaux indicateurs établissant leur niveau de confiance dans une notation. Les notations ne sont que des avis sur la probabilité de défaillance ; en conséquence, des instruments financiers structurés ont été notés AAA en dépit du fait que les informations sur lesquelles se fondait cette évaluation dataient de deux ou trois ans. En outre, ces produits n'avaient pas encore fait leur preuve dans un contexte de crise des marchés. Si l'on avait disposé de davantage d'informations sur ces produits, la qualité aurait été bien supérieure. Sur le marché des financements structurés, la dynamique de concurrence était une sorte de nivellement par le bas, c'est-à-dire que les ANF rivalisaient d'ingéniosité pour trouver les critères qui leur permettraient de loger le plus grand nombre d'émissions dans la tranche AAA, ce qui renforçait l'incitation à démanteler les normes prudentielles existantes. Si les ANF avaient été l'objet d'une surveillance attentive, y compris de la part des investisseurs, elles auraient tout de même rivalisé, mais sur le plan de la qualité. Toutefois, pour que le modèle investisseur-payeur fonctionne, il serait très difficile d'ignorer les notations des différentes ANF sur un produit donné et il n'est pas facile pour elles de les maintenir dans la sphère privée. En outre, le modèle émetteur-payeur a pour effet de limiter les notations, ce qui n'est pas la meilleure option.

Le Professeur Coffee remarque que l'on a débouché sur un point de désaccord et que la crise montre une chose, c'est que l'autorégulation des ANF est un échec retentissant. Le code de l'OICV part d'une bonne intention, mais ne va pas assez loin, car il n'a pas arrêté la forte motivation à gonfler les notations en réponse à la nécessité de conserver les parts de marché. La question de la possibilité d'obtenir des informations sur les résultats est la raison d'être des autorités de contrôle. Une autorité de contrôle peut recevoir des informations de chaque ANF et produire des statistiques comparatives des résultats des notations par classe d'actifs, sur les titres adossés à des créances hypothécaires et les titrisations de créances adossées à des actifs résidentiels ou d'entreprise. La SCC réalise actuellement ce travail et une convergence réelle est en train d'émerger entre les États-Unis et l'Europe. Les États-Unis se sont dotés d'un système d'enregistrement obligatoire, qui comprendra des éléments ayant trait à la concurrence comme l'égalité d'accès et d'autres règles pour garantir la transparence et publiera des statistiques de performance dès qu'elles seront disponibles. L'Autorité européenne des marchés financiers, une fois en place, devrait elle aussi s'atteler aux questions de statistiques comparatives de performance qui armeront les investisseurs. Les investisseurs ne disposent pas aujourd'hui d'informations adéquates et une autorité centrale de contrôle est nécessaire, utilisant des critères communs. Autrement, les différentes entités se noteront elles-mêmes, chacune selon ses propres critères et ses propres statistiques.

Le Professeur Langohr répond qu'il faut qu'il existe une demande d'informations, sinon la transparence ne sert à rien. Les ANF publient toutes des statistiques de performance sur leur site Internet, gratuitement, et cela prend un peu de temps pour mettre en place une mesure uniforme de ces statistiques de performance, mais cela ferait partie du processus de notation. Jusqu'ici, l'autorégulation n'a pas été proprement testée, puisque depuis 1975 et l'introduction du statut NRSRO, les notations sont intégrées dans la réglementation. On l'utilise par conséquent comme une mesure ou même une excuse pour les investissements malavisés.

Le Professeur Coffee indique qu'il a été démontré que le modèle par abonnement n'était pas viable sans le soutien des pouvoirs publics et dans le cadre de l'autorégulation, il aboutirait à un oligopole.

*** * ***

En guise de conclusion, le Président énonce les points suivants :

- Si les ANF ne se trouvent pas à l'origine de la crise, leurs faiblesses ont mise en évidence la **nécessité d'une réforme** du marché de la notation financière et des modèles utilisés.
- Le marché de la notation financière est **un oligopole naturel** et il est donc difficile de renforcer la concurrence.
- Il est nécessaire que les ANF renforcent leurs **contrôles préalables** pour s'assurer que les informations entrant dans les modèles qu'elles utilisent sont vérifiées et documentées.
- Il convient d'envisager le passage à un modèle dans lequel **l'investisseur joue un rôle** afin de limiter les conflits d'intérêt et de promouvoir l'indépendance des ANF.
- Il est peut-être préférable que **la réglementation fasse moins usage** des notations.
- La réglementation actuelle applicable au marché de la notation financière ne va pas assez loin et **les travaux doivent se poursuivre** dans ce domaine.

RATINGS REFORM: THE GOOD, THE BAD, AND THE UGLY

Note by Prof. John Coffee, Jr. [*]

Broad consensus exists that inflated credit ratings and conflict-ridden rating processes played a significant role in exacerbating the 2008 financial crisis.[1] For a variety of reasons – including the shared oligopoly that the major rating agencies enjoy, their virtual immunity from liability, and the conflicts of interest surrounding their common "issuer pays" business model – the major credit rating agencies ("CRAs") simply had too little incentive to "get it right." Indeed, the margin by which they did not "get it right" now seems extraordinary.[2] By one estimate, 36% of all Collateralised Debt Obligations ("CDOs") that were based on US asset-backed securities had defaulted by July 2008.[3]

Beyond the recognition that the CRAs failed and that their efforts and performance were compromised by serious conflicts of interest, little consensus exists, particularly among academics, on the shape of reform. Numerous reforms have been proposed by numerous champions, but fundamental disagreements divide even the most trenchant critics of the CRAs. Many view the CRAs as gatekeepers possessing reputational capital that they pledge to generate investors confidence in their ratings.[4] From this "reputational capital" perspective, conflicts of interest become the principal problem, as the CRAs may willingly (even cynically) sacrifice some reputational capital for enhanced revenues, at least so long as barriers to entry remain high and their legal liability stays low. From a different perspective, however, the CRAs are viewed less as informational intermediaries (or "gatekeepers") and more as holders of regulatory licenses that enabled them to exploit their quasi-governmental power for self-interested purposes.[5] Some even doubt that the market needs credit rating agencies, believing that their role could and should be replaced by alternative mechanisms, including greater reliance on credit spreads.

---

[*] This paper was originally prepared for, and presented at, the OECD in Paris, France in June, 2010 and has been updated to reflect the passage of the Dodd-Frank Act and related developments. John C. Coffee, Jr. is the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Centre on Corporate Governance.

[1] Reflecting this consensus, the Group of Twenty (G20) announced in April, 2009 their agreement on the need for "more effective oversight of the activities of Credit Rating Agencies." See Global Plan Annex: Declaration on Strengthening the Financial System Statement Issued by the G20 Leaders, April 2, 2009, London.

[2] For the finding that the ratings on structured finance products were highly inaccurate, see Joshua D. Coval, Jacob W. Jurek, and Erik Stafford, Economic Catastrophe Bonds, 99 Amer. Eco. Rev. 628 (2009); see also Joshua D. Coval, Jacob W. Jurek, and Erik Stafford, The Economics of Structured Finance, 23 J. Econ. Persp. 3 (2009). For criticisms of the rating process and practices such as ratings shopping, see Efraim Benmelech and Jennifer Dlugosz, The Alchemy of CDO Credit Ratings, 56 J. of Monetary Economics 617 (2009).

[3] See John Patrick Hunt, Credit Rating Agencies and the "Worldwide" Credit Crisis: The Limits of Reputation, the Insufficiency of Reform and A Proposal for Improvement, (available at http://ssrn.com/abstract=1267625) at 12.

[4] For a statement of this view (and a recognition of its limits), see John C. Coffee, Jr., GATEKEEPERS: The Professions and Corporate Governance (Oxford University Press 2006).

[5] The leading proponent of this view that ratings-dependent regulation should be dismantled is Professor Frank Partnoy. See Frank Partnoy, The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Rating Agencies, 77 Wash. U. L. W. 619 (1999); see also Partnoy, Overdependence on Credit Ratings Was a Primary Cause of the Crisis, (available at http://ssrn.com/abstract=1430653).

Thus, while those who start from the "gatekeeper" perspective tend to favour reforms aimed at reducing conflicts of interest (either by increasing CRA liability or restricting the issuer's ability to choose the rating agency), those who take the "regulatory license" perspective favour deregulation that ends the need for regulated financial institutions to obtain investment grade ratings before investing. This tension was evident in the drafting of the US's recent financial reform legislation – the Dodd-Frank Act – which largely straddles this gap. But if the deregulatory approach is taken, it leads to a further problem: How should financial institutions (such as money market funds) be regulated once it is acknowledged that in competitive markets these firms may be under pressure to take on excessive risk in order to obtain above-market returns? Can regulators define "creditworthy" investments with sufficient precision to enable them to end their current reliance on credit ratings?

The choice is fundamental. Although it is desirable to discourage unthinking reliance by investors on credit ratings, the implications of any mandatory downsizing of the role of the CRAs (beyond that which will naturally occur in a market dissatisfied with their performance) are uncertain. For some industries (such as housing finance) that depend upon asset-backed securitisations, access to capital may depend upon ratings that are credible, because "do-it-yourself" financial analysis of opaque debt instruments is simply not feasible for most financial institutions. Also, if the current reliance on investment grade credit ratings were ended, the manner by which sensitive financial institutions (most notably, money market funds) should be regulated remains unresolved. Are they to be given carte blanche to invest in any form of debt security? If not, can state and federal regulators define credit worthiness in comprehensible and comprehensive terms? Deficient as the CRAs have been, it is not obvious that governmental agencies can do much better, either at promulgating required standards of creditworthiness or in providing their own credit ratings.

Agreement, does, however, exist on one score: all want increased competition among CRAs. But, as will be seen, the impact of increased competition is problematic; it can encourage ratings arbitrage, as issuers pressure competing rating agencies to relax their standards. In any event, a feasible path to increased competition from the current starting point of oligopoly is far from obvious. The barriers to entry into this field are likely to remain forbiddingly high. Quite simply, the "Catch 22" for new entrants is that it is nearly impossible to obtain clients without a track record for reliable ratings and such a track record is difficult to generate unless one first has clients. Thus, to generate competition, some governmental intervention appears necessary. Possible such responses include: (1) authorising an independent body to select the rating agency; (2) mandating (and thereby effectively subsidising) a "subscriber pays" model for ratings; and (3) creating a governmental rating agency to issue ratings (much like the TVA was created in the United States as a check on the monopoly power of private utilities). Evaluating these options and the defining the regulatory objectives of enhanced oversight will be a focus of this paper.

After a brief review of the latest empirical evidence on the failure of the CRAs, this paper will argue that the conflict inherent in the dominant "issuer pays" business model and the concentrated character of the CRA market require an interlinked solution that either (1) divorces issuer payment of the CRA from issuer selection of the CRA, or (2) encourages (and implicitly subsidises) an alternative "subscriber pays" market for ratings.

Unlike more thorough-going critics of the CRAs, this article recognises (as does a recent study by the staff of the New York Federal Reserve Bank[6]) that the CRAs do provide valuable information that strongly influences the cost of capital. At least in the case of complex and opaque debt securities (such as collateralised debt obligations or "CDOs"), "do-it-yourself" credit analysis, even by relatively sophisticated institutional investors, is no more feasible than "do-it-yourself" brain surgery. Thus, reform of the CRAs is to be preferred over free market solutions that permit anyone to issue credit ratings and anyone to rely on them. That premise appears also to be shared by the US Congress, Canada, and the EU

6 See Adam Ashcraft, Paul Goldsmith-Pinkham, and James Vickery, "MBS Ratings and the Mortgage Credit Boom" (Staff Report No. 449, May, 2010).

Commission, which have all recently introduced systems for the mandatory registration and oversight of CRAs. Nonetheless, some downsizing of the mandatory role of credit ratings may be part of a balanced policy approach.

Because this paper covers European as well as US developments, it must be underscored at the outset that context counts – particularly in two critical respects. First, the institutional culture and regulatory options available in the US and Europe differ. The United States characteristically relies on private enforcement and civil litigation to deter wrongdoing, and the recent US legislation continues this tradition. These litigation options are less relied upon in Europe, where the class action and contingent fee are not generally recognised and where "white collar" criminal enforcement is less common. Public enforcement and regulatory negotiation tend to be the favoured levers in Europe. Similarly, Europe has not accorded the credit rating agencies the same de facto regulatory power as the United States has, with the result that downsizing their regulatory role may be a less important objective in Europe.

Second, the failure of the CRAs was almost uniquely with respect to structured financial products. Similar problems have not characterised the ratings of corporate bonds. Arguably, the necessary reforms can be safely limited to the lucrative and opaque context of structured finance. As next discussed, the conflicts were stronger and the prospects for ratings arbitrage greater in the case of structured finance.

1. What Went Wrong?: A Summary of the Criticisms and the Recent Evidence

Although the following criticisms overlap, each involves a different aspect of the problem:

1.1 The CRAs Ignored Massive and Rapid Deterioration in the Creditworthiness of Subprime Mortgages and Significantly Inflated Their Ratings after 2000

The rapid deterioration in credit quality associated with subprime mortgages is shown by the following table:[7]

Exhibit A

	Low/No-Doc Share	Debt Payments/Income	Loan/Value	ARM Share	Interest-Only Share
2001	28.5%	39.7%	84.0%	73.8%	0.0%
2002	38.6%	40.1%	84.4%	80.0%	2.3%
2003	42.8%	40.5%	86.1%	80.1%	8.6%
2004	45.2%	41.2%	84.9%	89.4%	27.3%
2005	50.7%	41.8%	83.2%	93.3%	37.8%
2006	50.8%	42.4%	83.4%	91.3%	22.8%

7 Jennifer E. Bethel, Allen Ferrell & Gang Hu, Law & Economic Issues in Subprime Litigation, Harvard John Olin Center for Law, Economics, and Business Discussion Paper No. 612 (March 2008). A more recent study by the staff of the Federal Reserve Bank of New York finds that the percentage of "low/no-doc mortgages" in subprime mortgage securitizations rose from 24.8% in 2001 to 46% in 2006 and 45.1% in 2007. Similarly, the percentage of "interest-only" mortgages in subprime mortgage deals rose from 0% in 2001 to 21% in 2006 (and then declined to 16.4% in 2007). Although these changes are slightly less stark, this same study found that on "Alt-A deals" (which are slightly more creditworthy than subprime mortgages), "low/no-doc" loans rose from 66.3% in 2001 to 79.3% in 2007, and "interest-only" loans rose from 0.4% in 2001 to 62.3% in 2007 – an even more dramatic transition. See Adam Ashcraft, Paul Goldsmith-Pinkham, James Vickery, "MBS Ratings and the Mortgage Credit Boom," (FRBNY Staff Report No. 449, May 2010). Thus, from both sources, the same picture emerges of an extraordinary deterioration in creditworthiness over a brief period.

As it shows, "low document" loans (or "liars' loans" in the US parlance) almost doubled over a five year period and came to represent the majority of subprime loans. Moreover, adjustable rate mortgages (or "teaser" loans with initially low interest rates that later steeply climbed) grew to over 91% of all such loans. Interest-only loans (which imply that the borrower could not afford to amortise the principal on the loan) rose to nearly 23% of such loans by 2006. But ratings did not change to reflect these trends.

In overview, the securitisation process seems to have led to lax screening by loan originators. One study finds that the highest rates of default occurred on loans sold by the loan originator to an unaffiliated financial firm,[8] and another finds that a loan portfolio that was securitised was 20% more likely to default than a similar portfolio that was not securitised.[9] The implication seems obvious: loan originators dumped their weaker loans on investment banks that were seeking to assemble quickly loan portfolios for securitisations.

These trends, particularly the absence of adequate documentation, should have been evident to the CRAs. Why were they oblivious? Here, three distinctive facts about changes in the structured finance market over the last decade need regulatory attention. First, as structured financed issuances overtook corporate debt issuances (by around 2002), the nature of the CRA's clientele changed. When the CRAs principally rated corporate bonds, no one client accounted for 1% of their business (because even large corporations went to the bond market only intermittently). But as structured finance became the CRAs' principal profit centre, the rating agencies faced a limited number of large investment banks that brought deals to them on a continuing basis (and thus could threaten to take a substantial volume of business elsewhere, if dissatisfied). The high level of concentration in the market for subprime mortgage securitisations is shown by Exhibit B below:

Exhibit B

MBS Underwriters in 2007: A Very Concentrated Market

Rank	Book Runner	Number of Offerings	Market Share	Proceed Amount + Overallotment Sold in US ($mill)
1	Lehman Brothers	120	10.80%	$100,109
2	Bear Stearns & Co., Inc.	128	9.90%	$91,696
3	Morgan Stanley	92	8.20%	$75,627
4	JP Morgan	95	7.90%	$73,214
5	Credit Suisse	109	7.50%	$69,503
6	Bank of America Securities LLC	101	6.80%	$62,776
7	Deutsche Bank AG	85	6.20%	$57,337
8	Royal Bank of Scotland Group	74	5.80%	$53,352
9	Merrill Lynch	81	5.20%	$48,407
10	Goldman Sachs & Co.	60	5.10%	$47,696
11	Citigroup	95	5.00%	$46,754
12	UBS	74	4.30%	$39,832

8 Atif Mian and Amir Sufi, The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis, NBER Working Paper No. W13936 (April 2008).

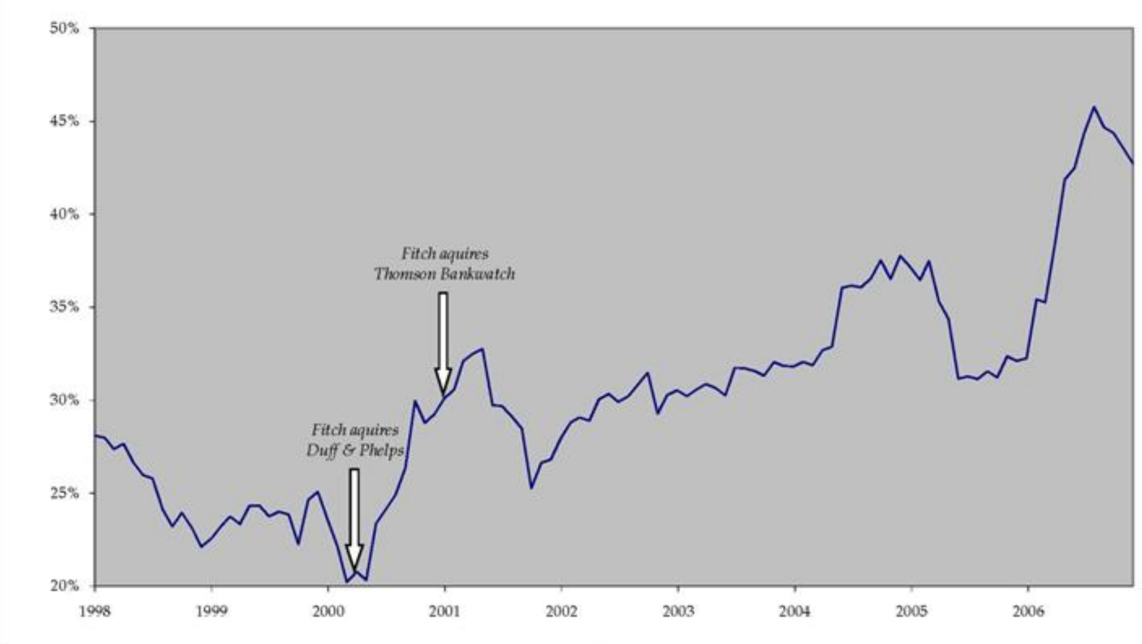
9 B. Keys, T. Mukherjee, A. Seru, & V. Vig., Did Securitization Lead to Lax Screening? Evidence from Subprime Loans, 2001-2006, (available at http://ssrn.com/abstract=2093137).

As this table shows, the top six underwriters listed above controlled over 50% of this market, and the top dozen accounted for over 80%. As a result, they possessed the ability to threaten credibly that they would take their business elsewhere – a threat that the rating agencies had not previously experienced. In recent testimony before a US Senate Committee, a former Managing Director of Moody's with responsibility for supervising their subprime mortgage ratings testified that it was well understood within Moody's that even a small loss of market share would result in a manager's termination.[10]

This development was exacerbated by the second major change occurring in this market in the decade prior to 2008: namely, heightened competition among the CRAs, caused by the rise of Fitch Ratings. As Becker and Milbourn have shown,[11] Fitch's monthly share of US credit ratings between 1998 and 2006 rose from a low of 20% in 2000 to a peak of 45% in 2006:

Figure 1: Fitch monthly market share of credit ratings (US issuers)

12 month moving average 1998-2006



This sharp rise was the consequence of a series of acquisitions of smaller rating agencies (Duff & Phelps and Thomson Bankwatch) that Fitch's new parent undertook in 2000 as part of a strategy to build up Fitch's market share.

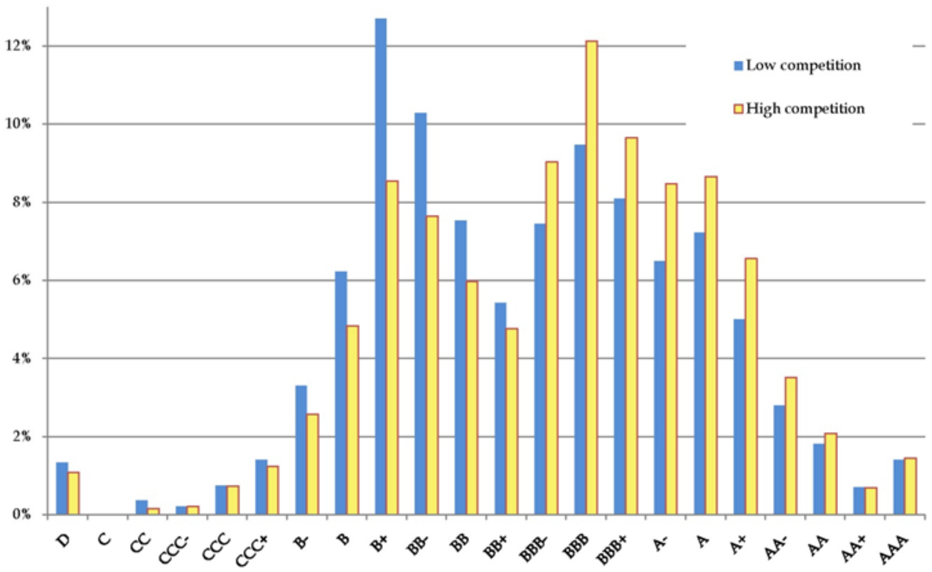
For many commentators, competition is exactly what the market for credit ratings needed. But Becker and Milbourne find that it in fact led to a significant inflation in ratings. As the following diagram shows, the percentage of investment grade ratings went up with greater competition, and the percentage of non-investment ratings went down – in both cases for every rating:

---

10 See Statement of Eric Kolchinsky before the Senate Permanent Subcommittee on Investigations, April 23, 2010 at 1-3.

11 Bo Becker and Todd Milbourn, Reputation and Competition: Evidence from the Credit Rating Industry, HBS Finance Working Paper 09-051 (2008).

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



By no means does this data truly prove that competition cannot work, but the shift from a duopoly to a three-way oligopoly appears to have challenged both Moody's and S&P. A recent Congressional hearing featured former employees of the CRAs who testified that their firm's culture changed around 2000, and the loss of even a small percentage of market share produced pressure from within the firm to relax rating standards.[12]

The third secular change that adversely affected CRA performance was the sharp reduction after 2000 in factual verification and due diligence. Factual verification of the creditworthiness of securitised mortgages largely disappeared after 2000, as investment banks and deal arrangers ceased to pay for such activities, and CRAs did not insist on their continuation. Although this development will be discussed in more detail later, it appears to have been driven less by the desire to economise on expenses than by a desire to suppress the "red flags" that factual investigations would uncover about the deterioration in credit quality in the subprime mortgage field.

1.2 How Were Ratings Inflated?: The Role of Discretion in Ratings

The foregoing discussion has emphasised the significance of conflicts of interest in the rating process. But how did these conflicts actually impact the rating process? Here, the real question is: why were risky subprime mortgages able to be rated investment grade (and, more specifically, AAA) when they were collected into portfolios? The initial answer, of course, involves tranching and elaborate subordination. In theory, collateralised debt obligations ("CDOs") received AAA ratings, because rating agencies concluded that sufficient debt obligations had been subordinated to the senior tranche to justify rating that senior tranche AAA. In light of their subsequent failure, however, the question becomes: was the level of subordination sufficient? Here, a recent 2010 study by Griffin and Tang of 916 CDOs issued between January 1997 and December 2007 finds that the CRAs did not follow a consistent policy or valuation model with respect to subordination, but rather regularly made "adjustments" on subjective grounds.[13]

---

[12] See Statement of Eric Kolchinsky, supra note 10.

[13] See John M. Griffin and Dragon Yongjun Tang, Did Subjectivity Play A Role in CDO Credit Ratings?, (available at http://ssrn.com/abstract=1364933) (2009).

Although these adjustments could be either positive or negative, 84% of these adjustments were in fact positive, and these adjustments increased the size of the top-rated AAA tranche by "an additional 12.1% of the AAA at the time of issue."[14] These discretionary adjustments, they find, "explain why CDO tranches are large and similar in size despite varying CDO structures."[15] Less surprisingly, they further find that the amount of the adjustment was positively correlated with future downgrades. In short, the evidence shows not that the CRAs' valuation models were wrong, but that they were systematically overridden in a manner that increased the size of AAA tranches.

The degree to which CRAs overrode their own models to increase the size of the senior tranche that could now be rated AAA appears both extraordinary and largely based on discretionary upward adjustments. Griffin and Tang report that "only 1.4% of AAA CDOs closed between January 1997 and March 2007 met the rating agency's reported AAA default standard,"[16] with the rest falling short. Ultimately, they "estimate that the AAA tranches would have been rated BBB on average" and that the aggregate overvaluation of the CDOs in their sample of 916 CDOs was $86.22 billion.[17]

In making these discretionary adjustments, the CRAs appear to have been acquiescing in the desires of the investment banks that engineered these securitisations. By increasing the size of the AAA tranche, the rating agencies made the CDO both more valuable and, at least as important, easier to sell (as lower rated tranches could only be sold to a much smaller audience). Hull estimates that often as much as "$90 of AAA-rated securities [were] ultimately created from each $100 of subprime mortgages."[18] Because subprime borrowers are by definition poor credit risks, he estimates that the typical subprime borrower "would at best be rated BBB" and thus, he finds, it was highly unlikely that any financial alchemy could generate $90 of AAA-rated instruments from $100 of BBB-rated mortgages.[19]

The conclusions reached by Griffin and Tang have recently been expressly confirmed by an even larger study by the staff of the New York Federal Reserve Bank.[20] Using a uniquely large data set that covered 60,000 MBS securities issued between 2001-2007, or "nearly 90% of the deals issued during this period,"[21] they find that risk-adjusted subordination declined "significantly between the start of 2005 and 2007"[22]; as a result, a greater percentage of the total offering was rated AAA. Their most striking finding is that "deals with a high share of low- and no-documentation loans ("low doc") perform disproportionately poorly, even relative to other types of risky deals" – implying to them that these loans were not rated conservatively enough on an ex ante basis.[23] Unlike other studies, they do not find a steady decline from 2001 to 2007, but rather a sudden decline in 2005 to 2007, when a record number of deals came to market and when (in their view) the reputational costs of error became modest in relation to the expected profits to the ratings agency.

---

14 Id. at 4.

15 Id.

16 Id.

17 Id. at 5.

18 John Hull, Credit Ratings and the Securitization of Subprime Mortgages, (Paper presented at the Federal Reserve Bank of Atlanta 2010 Financial Markets Conference, "Up from the Ashes: The Financial System After the Crisis," May 11, 2010) at 4-5.

19 Id. at 4-5. In fact, on the typical "Alt-A deal," the earlier noted Federal Reserve Bank study finds that, over the period from 2001 to 2007, $100 of "Alt-A" mortgages generated on average approximately $93.1 of AAA-rated CDO debt securities. See Ashcroft, Goldsmith-Pinkham and Vickery, supra note 7, at Table 3.

20 See Ashcraft, Goldsmith-Pinkham, and Vickery, supra note 7, at 31.

21 Id. at 2.

22 Id. at 3.

23 Id. at 3-4.

Although CDOs were supposed to be supported by a foundation of subordinated junior tranches, the level of subordination was always thin. In the case of subprime deals, the AAA tranche constituted on average 82.4% of all the securities in the portfolio over the period from 2001 to 2007 (and some years was over as 90%), and in "Alt-A deals," the AAA-rated tranche represented over 93% of the securities in the CDO pool over the same period.[24]

This willingness of the ratings agencies to tolerate "thin" subordination and award AAA ratings to top-heavy securitisation structures transcended the special field of subprime mortgages. In the related field of commercial mortgage-backed securitisations ("CMBS"), there was no general decline in the quality of the collateral (as there was in the case of residential mortgages), and the rate of default on such loans did not increase appreciably. Thus, ratings should have remained relatively reliable. Yet, studying a comprehensive sample of CMBS transactions from 1996 to 2008, Stanton and Wallace find that the CMBS market collapsed during the 2008-2009 financial crisis because ratings agencies permitted subordination levels to be reduced by issuers until they provided insufficient protection for the supposedly safe senior tranches.[25] This finding undercuts the argument of the ratings agencies that they were blindsided by sudden changes in the subprime mortgage arena. To the contrary, the rating agencies appear to have tolerated thin subordination across a variety of contexts, as issuers and underwriters pressured them to compete.

1.3 Unique Among Gatekeepers, the CRAs Did Not Verify or Confirm Factual Information Upon Which Their Models Relied.

Unlike auditors, securities analysts, attorneys, investment banks and other financial gatekeepers, CRAs do not conduct factual verification with respect to the information on which their valuation models rely.[26] While accountants are quite literally "bean counters" and security analysts contact all possible sources of information (customers, suppliers, rivals) to obtain information about an issuer, CRAs simply disclose that they are relying on information supplied to them by others. The problem, of course, is that no model, however well designed, can outperform its informational inputs; unverified data results in the well-known "GIGO Effect" – Garbage In, Garbage Out.

Due diligence did, however, use to be part of the process. Prior to 2000, the ratings agencies usually had a generally reliable source of information about the quality of the collateral in securitisation pools. During this period prior to 2000, investment banks outsourced the task of due diligence on asset-backed securitisations to specialised "due diligence" firms. These firms (of which Clayton Holdings, Inc. was probably the best known) would send squads of loan reviewers to sample the loans in a portfolio to be purchased from a financial institution or loan originator, checking credit scores and documentation. Although this sampling fell well short of an audit, it could identify the likely percentage of "problem" loans in the portfolio. But the intensity of this due diligence review declined after 2000. The Los Angeles Times quotes the CEO of Clayton Holdings to the effect that:

> *"Early in the decade, a securities firm might have asked Clayton to review 25% to 40% of the sub-prime loans in a pool, compared with typically 10% in 2006…"*[27]

---

24 Id. at Table 3.

25 See Richard Stanton and Nancy Wallace, "CMBS Subordination, Ratings Inflation and the Crisis of 2007-2009," NBER Working Paper No. 16206 (July 2010) (available at http://ssrn.com/abstract=1648006).

26 For this conclusion, see U.S. Securities and Exchange Commission, "Summary Report of Issues Identified in the Commission's Staff's Examination of Select Credit Rating Agencies" (July 2008) at p. 18 (noting that CRAs "did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated.").

27 See E. Scott Reckard, "Sub-Prime mortgage watchdogs kept on leash; loan checkers say their warnings of risk were met with indifference," Los Angeles Times, March 17, 2008 at C-1.

The President of a leading rival due diligence firm, the Bohan Group, made an even more revealing comparison:

> *"By contrast, loan buyers who kept the mortgages as an investment instead of packaging them into securities would have 50% to 100% of the loans examined, Bohan President Mark Hughes said."28*

In short, lenders who retained the loans checked the borrowers reasonably carefully, but the investment banks decreased their investment in due diligence, making only an increasingly cursory effort as the bubble inflated. This evidence is consistent with the earlier finding that loans in a securitised portfolio defaulted at a significantly higher rate.

The actual "due diligence" personnel employed by these firms also told the above-quoted Los Angeles Times reporter that supervisors in these firms would often change documentation in order to avoid "red-flagging mortgages." These employees also report regularly encountering inflated documentation and "liar's loans," but, even when they rejected loans, "loan buyers often bought the rejected mortgages anyway."[29] In short, even when the watchdog barked, no one at the investment banks truly paid attention, and no one told the rating agencies.

All these elements converge to support a classic "moral hazard" story: those who did not expect to hold these loans for long invested increasingly less in investigating their creditworthiness and indeed repressed adverse information by ceasing to inquire. Concomitantly, they began to subordinate less of the portfolio in riskier tranches in order to increase the size of the more valuable top-rated tranche. The bottom line then appears to be that an "originate and distribute" business model does lead to lax screening and deceptively below average loan portfolios.

Other critiques of the CRAs have also been convincingly made: (1) they were slow to revise their ratings or downgrade securities; (2) they tend to "herd" or converge over time on a common rating (probably because a common error does not result in unique reputational damage);[30] and (3) they did not adequately disclose their valuation models. But these critiques, while probably valid, had less to do with the 2008 financial crisis and so will receive less attention.

2. The Debate over Possible Reforms: Where to Place Society's Bets

CRA failure is an important aspect of the broader problem of systemic risk. Unless a reliable watchdog can monitor the creditworthiness of CDOs and other asset-backed securitisations, these securities will either remain unmarketable or will endure highly volatile "boom and bust" cycles. Still, reformers divide between (1) those who want to subject CRAs to closer regulation to purge the rating process of conflicts of interest, and (2) those who believe that the answer is deregulation through downsizing the role of credit ratings. This section will briefly review recent developments and then survey the range of reforms that have been proposed.

---

[28] Id.

[29] Id.

[30] See Andre Gutler, Lead-Lag Relationships and Rating Convergence Among Credit Rating Agencies, (European Bus. Sch. Research Paper No. 09-14, 2009) (available at http://ssrn.com/ abstract=1488164) (finding that Moody's closely tracks S&P upgrades, but not its downgrades). Such "upside" herding only cannot be attributed to a quantitative model, but appears discretionary.

2.1 Developments over the Last Five Years

2.1.1 The United States

In both the United States and Europe, credit rating agencies were not directly regulated for most of their existence. On the statutory level, this changed only in 2006 in the United States, and prospective changes have only been proposed this year in Europe. However, although the CRAs were not regulated, many institutional investors were. In the United States, banking and financial regulators have long required institutional investors and broker dealers to obtain ratings for debt securities they wished to hold in their portfolios in order to enable prudential-based regulation to distinguish safe investments from speculative ones. Beginning in 1975, the SEC required that such ratings be issued by "nationally recognised statistical rating organisations" ("NRSROs").[31] Effectively, this NRSRO requirement meant that rating agencies not so designated by the SEC could not issue ratings on which institutions and broker-dealers could rely for these regulatory purposes. CRAs excluded from the "NRSRO" club were thus prejudiced because their ratings carried a lesser value.

Curiously, the SEC never officially defined the term "NRSRO," nor did it establish formal criteria governing admission to the NRSRO club. Instead, the SEC's staff used a vaguer and ultimately question-begging test that looked to whether an applicant was "nationally recognised by the professional users of ratings in the United States as an issuer of credible and reliable ratings."[32] Between 1975 and 2006, the SEC generally refused to confer the NRSRO designation on most credit rating applicants, apparently because it feared that new and "fly-by-night" rating agencies would be more generous in awarding investment grade ratings and thereby lead a race to the bottom.

The SEC's conservatism in approving new NRSROs drew criticism (particularly from excluded firms). Equally important, in the wake of the Enron, WorldCom and related corporate scandals in the 2001-2002 period, the existing NRSROs became politically vulnerable when they had clearly failed to detect approaching financial disasters (the often-cited illustration is that none of the NRSROs downgraded Enron until a day or two before its bankruptcy). Following a series of critical studies, Congress enacted the Credit Rating Agency Reform Act of 2006, which created an objective registration framework that sought to both facilitate entry by new agencies into the NRSRO market and to mandate greater accountability by existing NRSROs. Although the 2006 Act did authorise broad rule-making by the SEC to restrict conflicts of interest, it expressly denied the SEC the power to "regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings."[33] This compromise under which the SEC can restrict conflicts of interest, require disclosure, and monitor performance, but not regulate the methodologies or models by which ratings are determined reflected a Congressional view that the SEC lacked the expertise to prescribe models to the CRAs, but could evaluate the consistency of application by each CRA. This compromise will remain in force even under the currently pending legislation passed by the two houses of the US Congress.

Pursuant to the powers granted it by the 2006 Act, the SEC has promulgated a series of rules to (1) govern the registration procedure; (2) provide detailed disclosure as to the experience with the ratings issued by each NRSRO rating agency, (3) regulate conflicts of interest, and (4) encourage competition. Probably the most noteworthy of these rules is Rule 17g-5, which expressly prohibits some seven types of

---

31 For a fuller background, see John C. Coffee, Jr., GATEKEEPERS: The Professions and Corporate Governance (2006) at 293-297.

32 See U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies In the Operation of the Securities Markets (2003) at 9.

33 See Section 15E(c)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-7(c)(2).

conflicts of interest.[34] Even more importantly, Rule 17g-5 was amended in 2009 to create an "equal access" obligation. Under it, when an NRSRO is hired by an issuer or other arranger to determine an initial credit rating for a structured finance product, it must make available the information it receives from the issuer or arranger to other NRSROs (but not to the public generally) in order to enable them to issue their own ratings.[35] The intent of this "equal access" rule is to encourage competition by allowing potential competitors to obtain the same information given by the issuer to the CRA that it hires. In short, although this rule is based on the SEC's power to regulate conflicts of interest, its primary intent is to foster competition.

Pursuant to the 2006 Act, the SEC has been required to admit any NRSRO applicant that can make an adequate showing of competence, and the SEC has in fact expanded the number of NRSROs to ten (with several applications pending that are likely to be successful). Still, the Big Three (Moody's, Standard & Poor's and Fitch Ratings) have remained dominant (with the new CRAs largely focusing on specialised market niches or rating foreign firms based in their own jurisdiction). This result suggests that the regulatory power assigned to the Big Three by the NRSRO system does not truly explain their market dominance. Even during the 1975-2006 period, a few new entrants were admitted by the SEC to the NRSRO club, but they were unable to compete successfully (and were acquired by the Big Three). Uniquely, Fitch Ratings did become competitive with Moody's and S&P, but it had specialised in structured finance and thereby had acquired a competitive headstart over its rivals (Moody's was in fact slow to enter the structured finance field). Overall, this pattern suggests that there are important "first mover" advantages because reputational capital is hard to acquire and goes to the first firms in the field. If licensing power alone could explain the dominance of the Big Three, then the newer members of the SEC's "NRSRO Club" would have joined and shared in their oligopoly.

2.1.2 Europe

In comparison to the United States, Europe has traditionally not regulated CRAs. Following the Enron scandal in 2001, the Committee of European Securities Regulators ("CESR") conducted a study for the European Union Commission (the "Commission") that ultimately concluded that legislation was not necessary to regulate the CRAs. Instead, the Commission relied on a Code of Conduct developed by the International Organisation of Securities Commissions ("IOSCO") to ensure the accountability of the CRAs. The Commission designated CESR the responsibility of monitoring compliance with this Code and instructed CESR to report to the Commission annually. In 2006, after the first such report from CESR, the Commission again concluded that, although it saw problems with the performance of the CRAs, these problems were not sufficient to require legislation.[36]

Under the IOSCO Code of Conduct approach, each CRA adopted a voluntary code, typically using the IOSCO Code as its model. CRAs could deviate from the IOSCO Code if they chose, but they had to disclose any departures pursuant to the EU's traditional "comply or explain" system of self regulation.

Well established as the "comply or explain" model was in Europe, the 2008 financial crisis has caused Europe to abandon it in the case of the CRAs in favour of a mandatory system of registration and administrative supervision. The process began in 2009, when the European Parliament adopted a "Proposal

---

34 These seven prohibited conflicts (all set forth in Rule 17g-5(c)) are ably discussed in Lynn Bai, On Regulating Conflict of Interests in the Credit Rating Industry, 13 N.Y.U. J. Legis. & Pub. Pol'y _ (forthcoming in 2010). See also 17 C.F.R. Section 240.17g-5(c).

35 See Securities Exchange Act Release No. 34-61050 (November 23, 2009), 2009 SEC LEXIS 3798.

36 For a general overview, see Stephane Rousseau, "Regulating the Credit Rating Agencies After the Financial Crisis: The Long and Winding Road Toward Accountability" (available at http://ssrn.com/abstract=1456708 (2009)).

by the European Commission for a Regulation on Credit Rating Agencies."[37] This initial regulation introduced the principle of mandatory registration for credit rating agencies operating in Europe, but it was not then clear who would supervise the CRAs. Then, on June 2, 2010, the European Commission proposed a revision to this regulation to create a pan-European body – the European Security Markets Authority (or "ESMA") – that would be given exclusive supervisory authority over credit rating agencies registered in Europe.[38] Backstopping this supervision would be new powers given to the ESMA to investigate, impose fines, and suspend or terminate a CRA's license. The proposal requires approval by the European Parliament and member governments, but it is particularly noteworthy in that it would represent the initial pan-European body with day-to-day regulatory authority over the securities markets.

In some important respects, the EU Regulation resembles the SEC's approach, both in the requirement of registration and in a common "equal access" rule intended to promote competition. The ESMA, however, would have marginally greater authority than the SEC, because it would be empowered to evaluate the methodologies and procedures used by the CRA to rate securities. Under the proposed EU Regulation, CRAs must periodically review their methodologies, adopt reasonable measures to assure the reliability of the information relied upon by their models, and ensure that their employees are adequately trained and have appropriate knowledge and experience. In general, the EU Regulation is framed in broad and non-specific terms and at this stage focuses more on establishing a framework for supervision than on mandating specific prophylactic rules.

2.1.3 The New Convergence

As a result of the EU Regulation, recent amendments to the IOSCO Code of Conduct, and the SEC's rules, the US and Europe seem to be converging. Both SEC Rule 17g-5 and the IOSCO Code seek to reduce conflicts of interest by (1) barring an NRSRO or similar European CRA from issuing a rating with respect to an obligor or security where it has advised or consulted on the design or structuring of the security,[39] and (2) prohibiting an analyst who participates in the rating determination from negotiating the fee that the issuer or arranger pays for it.[40] The first prohibition is designed to discourage the provision of consulting services to issuers by rating agencies, and seems modelled on similar prohibitions in the Sarbanes-Oxley Act that precluded auditing firms from providing defined consulting services to audit clients for fear that the provision of such services would exacerbate conflicts of interest; the second prohibition on analyst involvement in fee negotiations similarly seeks to protect the professional independence of the analyst (much as the "global settlement" reached by US regulators in 2002 with the major investment banks sought to distance securities analysts from any involvement in marketing activities). Building on the IOSCO Code of Conduct, the EU Regulation would similarly bar a rating agency from providing consulting or advisory services to a client whose securities it is rating.

Convergence is also evident in the common requirements under the SEC rules and the EU Regulation that CRAs disclose their methodologies, models and key rating assumptions. Similarly, recent revisions to the IOSCO Code follow the SEC in endorsing a form of an "equal access" rule under which issuers are

37 See Regulation 1060/2009, OJL 302, 17.11.2009, p. 1.

38 For overviews of this proposal, see James Kanter, "EU seeks oversight of rating agencies," The International Herald Tribune, June 3, 2010, at p. 15; "EC waves big stick, rival at rating agencies," The Australian, June 4, 2010, at p. 28.

39 SEC Rule 17g-5(c)(5) bars an NRSRO issuer from issuing or maintaining a rating where it (or any associated person) "made recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security." See 17 C.F.R. Section 240.17g-5(c)(5) (2009).

40 SEC Rule 17g-5(c)(6) prohibits an NRSRO from issuing or maintaining a credit rating "where the fee paid for the rating was negotiated, discussed or arranged by a person within the NRSRO who has responsibility for participating in, determining or approving credit ratings..." See 17 C.F.R. Section 240.17g-5(c)(6) (2009).

encouraged to make public disclosure of all information provided by an issuer that is used by a CRA in rating an asset-backed security. If established, ESMA would presumably make this norm mandatory.

Given this high level of convergence (albeit with fewer mandatory rules or enforcement mechanisms in Europe), the important questions become: (1) What important topics have not yet been addressed?; and (2) Are there areas in which Europe and the US do not agree? One obvious example of the latter is the reported plan of the European Commission to establish a regional European rating agency to compete with the Big Three.[41] No similar idea has been proposed in the US At least in part, this proposal appears attributable to the fact that Moody's and S&P are American firms and, perhaps even more, to the action of the Big Three in recently downgrading European sovereign debt (most notably that of Greece) in a manner that was perceived to have exacerbated the recent European financial crisis in 2010.

In addition, although some conflicts of interest have been addressed, neither the SEC nor the EU Commission has yet addressed the "issuer pays" business model of the CRAs or the highly concentrated character of the CRA market. The next section surveys these areas.

2.2 An Overview of the Choices Not Yet Faced

In some areas, the US and Europe still diverge; in other areas (such as the promotion of competition and the control of conflicts of interest), neither has yet fully resolved how to implement its goals.

2.2.1 Litigation and Deterrence-Based Reforms

Consistent with the US's preferences to rely on liability-based reforms, the US House of Representatives passed legislation in December, 2009, which contained a provision subjecting CRAs to liability for gross negligence. Section 6003(c) of H.R. 4173 provided that a purchaser of a rated security "shall have the right to recover for damages if the process of determining the credit rating was (1) grossly negligent, based on the facts and circumstances at the time the rating was issued, and (2) a substantial factor in the economic loss suffered by the investor." Differing markedly from the antifraud provisions in the Securities Exchange Act of 1934 (which generally require the plaintiff to plead and prove a fraudulent intent on the part of the defendant), this provision would have made it far easier for plaintiffs to sue a rating agency than to sue the issuer or underwriter of the security. In 1995, as a protection against "frivolous" litigation, the Private Securities Litigation Reform Act (or "PSLRA") adopted strict pleading rules that required a plaintiff in a securities fraud action to plead facts with particularity that "give rise to a strong inference of fraud" before it can obtain discovery. These rules would have been effectively inapplicable to a negligence-based action against a CRA and thus would have tilted the playing field substantially toward the plaintiff. Unusual as it is to hold a secondary participant legally responsible under a more relaxed and pro-plaintiff standard than the issuer, the House provision clearly reflected the Congressional (and public) anger at the rating agencies, who seem to many to have been the gatekeepers that failed the worst during the 2008-2009 financial crisis.

Utlimately, the US Congress declined to adopt the House's negligence standard and instead opted for the liability provision in the later passed Senate Bill. The Senate Bill (whose liability provision was drafted initially by this author and is later discussed in more detail) used a more traditional antifraud standard. Essentially, the Senate Bill coupled a fraud-based standard with a safe harbour that becomes applicable when the CRA conducts or obtains factual verification of the key elements in its ratings model. Thus, the Senate Bill's goal was more focused on encouraging due diligence than imposing damages.

Although the Dodd-Frank Act expressly enhances the liability of the CRAs, a Constitutional question mark still hangs over this area that could nullify this new liability provision. Some judicial decisions in the

---

41 See sources cited supra at note 38.

US have viewed credit ratings as expressions of opinion protected by the First Amendment.[42] The case law in the United States is currently divided on this question,[43] and no authoritative answer is possible until the Supreme Court addresses the issue.

Still, from a policy perspective, does negligence-based liability make sense? Although the case for enhanced liability may be strong, three distinct policy reasons suggest that a liberalised negligence standard is ill-advised. First, a negligence standard could easily bankrupt the CRAs, as a single case could produce a billion dollar (or greater) judgment. Second, the threat of a negligence standard could lead the CRAs to withdraw from rating risky structured finance products (and similarly chill new entrants from entering this field). Indeed, if the CRAs were to cease to rate structured finance products because of this standard, housing finance in the US might remain paralysed. Third, and most importantly, the appropriate legislative goal should be deterrence, not compensation. Given that trillions of dollars in structured finance products have been marketed globally, there is no realistic possibility that the credit rating agencies could fund meaningful compensation to most their victims. Their pockets are simply not deep enough to cover even a small percentage of the losses associated with structured finance.

If so, the realistic objective should be to focus deterrence on the CRAs so that in the future they conduct adequate due diligence and update their financial models to reflect new developments. On this premise, any cause of action against the CRAs should logically be coupled with a ceiling on liability to ensure that the deterrent threat does not lead to the financial destruction of an arguably necessary financial intermediary. Indeed, this danger is especially acute in the case of a CRA, because its mistakes are typically interlinked and involve multiple securities issuances. That is, an error in its valuation model or any shortcoming in its verification procedures may produce inflated ratings in the case of dozens (or even hundreds) of issuers (with billions of dollars in damages thereby resulting). In contrast, an error by an auditor will likely produce only inaccurate financial statements in the case of one issuer. Put differently, because a misjudgement by a CRA may enable a far greater dollar volume of securities to be sold, the need for deterrence is strong, but the case for a ceiling on its liability may even be stronger.

2.2.2 Employee Compensation-Based Reforms

In principle, the accuracy of a credit rating is only demonstrated over the long-run, but the payment for it is made in the short-run. This mismatch can create agency problems, as the managers who determine the rating may not expect (or intend) to be around at the end of the ratings cycle. In effect, they may hope to obtain incentive compensation in the short-run reflecting their firm's increased ratings revenue, even though their mispricing of risk has created a much greater long-term liability for their employer. To deal with this mismatch, some have proposed compensation constraints. For example, at the entity level, the fee to the CRA could conceivably be placed in escrow until the bond was paid off; alternatively, the law could entitle investors to "clawback" the fee if the rating proved inaccurate (i.e., in the event of a default, downgrade, or some other "credit event"). At the manager level, salaries or other compensation could be similarly clawed back by the rating agency. Alternatively – and perhaps more feasibly – the manager could become entitled to bonuses or other incentive compensation at the conclusion of the ratings cycle if the rating proved accurate.

---

42 For such holdings, see Jefferson County School District No. R-1 v. Moody's Investor's Services, Inc., 175 F.3d 848, 852-856 (10th Cir. 1999); In re Enron Corp. Securities Derivative & "ERISA" Litigation, 511 F. Supp. 2d 742, 752 (S.D. Tex. 2005).

43 Some recent decisions have refused to find the First Amendment applicable to ratings on structured finance products, because in the view of these courts no issue of public concern that merited First Amendment protection arises in the rating of the debt of a "special purpose entity" that was to be sold only to a limited group of institutional investors. See Abu Dhabi Commerical Bank v. Morgan Stanley & Co., Inc., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

Although logical in theory, these compensation-based proposals encounter overwhelming practical difficulties. Rating fees cannot easily be placed in escrow for the life of the bond without creating severe liquidity problems for the ratings agency. Equally important, if the rating proves inflated, the issuer who paid the CRA for that rating should hardly be entitled to a seeming windfall profit by enabling it to recapture its fee. Only the injured investor deserves any repayment, and it wants restitution of its loss, not a mere clawback of the rating agency's fees. Clawbacks directed at employees and former employees may also be difficult to enforce – particularly years after the inaccurate rating was issued. Nor is it clear that the CRA should be entitled to a clawback from its own analysts. Indeed, if the inflated rating was the result of pressure by the rating agency on its employee (backed up by the implicit threat of dismissal if the employee lost "market share"), then arming the employer with a right to "clawback" the employee's compensation rewards the principal culprit. In any event, employees who are motivated to inflate ratings by fear of demotion or dismissal are unlikely to find the distant threat of a clawback in future years sufficient to offset fully the shorter-term pressure.

Subtler variations on compensation formulas can be imagined. Listokin and Talbleson have suggested that rating fees should be paid to the CRA in the rated securities in order that the cost of the overvaluation of the rate securities would fall on the rating agency.[44] Clever as this idea is in principle, it would not work if the rating agency could immediately sell the debt securities before their misrating was discovered. If it cannot, it must hold a sizable portfolio of securities with resulting liquidity and legal problems.[45] Also, if the rating fee was a basis point (or less) of the deal size, this system would involve the issuance of small amounts of debt securities (and in odd denominations) to the rating agency. It is inefficient to hold or trade small quantities of a large number of illiquid debt securities (as the CRA would incur disproportionate brokerage fees).

2.2.3 Curbing Conflicts of Interest and the "Issuer Pays" Business Model

The most obvious conflict of interest that potentially undercuts the credit rating agency's independence and objectivity is the simple fact that the issuer pays the rating agency's fee. At some point in the mid-1970s, the credit rating agencies shifted to this business model after finding that they could be no more than marginally profitable operating on a subscription basis under which investors paid for their ratings.[46]

Obvious as the conflict in an "issuer pays" model is, two points must be immediately made about the realism of seeking to eliminate it: (1) Most financial gatekeepers – auditors, law firms, investment banks – operate under a similar model under which the issuer pays their fees; and (2) A "subscriber pays" model may be doomed to failure by the "public goods" nature of ratings. Because the rating agency cannot effectively prevent the communication of its ratings to non-paying investors once it discloses its ratings to its clients, it cannot capture the full value of the financial information that it creates. For example, a subscriber may leak the rating information to another institutional investor, possibly in return for some reciprocal favour (including disclosure of the rating issued by some other rating agency). As a result, free riders will inevitably acquire and rely on the information without compensating the creator – in effect, the standard "non-excludibility" criterion that defines a public good. Indeed, some have argued that the principal CRAs encountered this free riding problem in the early 1970s, which lead them to shift to the "issuer pays" model.[47]

---

44 See Yair Listokin and Benjamin Talbleson, "If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation," 27 Yale J. on Reg. 91 (2010).

45 For example, the CRA might become an "inadvertent" investment company under the Investment Company Act of 1940.

46 See Coffee, GATEKEEPERS: The Professions and Corporate Governance (2006) at 295-296.

47 Professor Lawrence White has suggested that this shift was attributable to the rating agency's inability to keep their ratings secret – in effect, their ratings became "public goods." Information technology – the

Thus, the more feasible response to the conflict of interest inherent in the "issuer pays" model may to permit the issuer to pay for the rating, but not to select the rater. This strategy would also respond to the independent problem of "rating shopping," under which issuers seek preliminary ratings and then choose the agency giving it the highest preliminary rating to issue the final rating.

From this starting point, the next step is to consider the alternative means by which the rating agency could be chosen. Three obvious alternatives are apparent, but each could be further refined in a variety of ways:

- **The Government as Hiring Agent**: The selection of the rating agency could be given to some independent agency. In 2010, the US Senate recently voted in favour of this option, approving by a large majority an amendment offered by Senator Al Franken (D-Minn.) to the then pending Dodd-Frank Act. The Franken Amendment would have created a "Credit Agency Review Board" (the "Board"), which would choose the initial rater for all "structured financial products." The issuer would remain free to (1) secure no rating at all, or (2) hire additional rating agencies if it wished. As proposed, the Board would be established under the SEC and subject to its oversight. Although the Board would not determine the fee to be paid by the issuer to the rating agency, the SEC is instructed by the legislation to place a "reasonable" ceiling on the fee (both to prevent overcharging by the rating agency and implicit bribery by the issuer).

  Ultimately, the Franken Amendment was watered down in the final revisions of the Dodd-Frank Act so that the SEC must first conduct a study of the feasibility of its approach. Following that study (which must be conducted within two years of the Act's passage), the SEC is authorised to adopt the equivalent of, or a variant on, the Franken Amendment.[48] In short, this proposal remains very much on the table for discussion and modification.

- **Encouraging a "Subscriber Pays" Model**: Another way to avoid issuer domination of the rating determination would be to require institutional investors to obtain their own ratings (and from a rating agency not retained by the issuer or underwriters) before they could purchase the debt securities. The issuer would also remain free to hire its own rating agency, but each institutional investor would need to obtain its own independent rating. The goal of this approach is to spur the growth of a "subscriber pays" market. Its key premise is that a "subscriber pays" market will not develop on its own (as it clearly has not to date) so long as investors are free to rely on an "issuer-paid" rating. Some reformers would go even further and seek to mandate or encourage the formation of investor owned rating agencies on the premise that they would be bias free.[49] Still, this belief that institutions will form their own ratings agencies probably posits a stronger investor interest in ratings reform than it is realistic to assume most institutions have. Nonetheless, even if institutions will resist expending funds on ratings, groups of institutions presumably might economise on their fees under a mandatory "subscriber pays" system by jointly hiring an independent rating agency at a discounted "wholesale" price. Thus, the costs to them are not prohibitive.

- **The Government Utility Model**: A last alternative is a government-created and managed rating agency, and the EU is currently considering such an approach on a regional basis. This "Governmental Utility Model" could be designed to be a check on the private market – much as

xerox, the fax machine, etc. – made it possible by the 1970s to easily distribute ratings that were revealed by the ratings agency only to the initial subscriber.

48 See Section 939F of the Dodd-Frank Act.

49 For such a proposal, see Joseph Grundfest and Evgeniya E. Hochenberg, "Investor Owned and Controlled Rating Agencies: A Summary Introduction," Rock Center for Corporate Governance Working Paper No. 66 (October 25, 2009) (available at http://ssrn.com/abstract=1494527).

the Tennessee Valley Authority ("TVA") was created in the US during the New Deal era as a check and yardstick by which to measure the performance of privately owned public utilities. That is, it would not be an exclusive rater, but investors would compare the Moody's or S&P rating against the governmental rating.

A Policy Evaluation. Each approach has its own advantages and disadvantages. Using the government (or its proxy) as the neutral party who selects the initial rating agency is simple and direct and should assure the independence of the chosen rater. More questionable, however, is whether the rating agency so chosen will have credibility. Conceivably, this approach potentially provides politicians with an enormous patronage system. How do we ensure that political loyalties and contributions do not influence the selection of the initial, government-appointed rating agency? The Franken Amendment provides that independent commissioners chosen by the SEC would perform this function, but it also permits its Credit Rating Agency Review Board to use either a lottery or a rotating assignment system. The sheer volume of initial ratings may compel such a mechanical approach because the Board may find it infeasible to make individualised decisions in every case.

Although random or rotation assignments might protect against political favouritism and probably would encourage new entrants to apply to become NRSROs (in the US parlance) in order to obtain initial rating assignments, the problem with such a system is that it creates little incentive for rating agencies to compete based on the quality of their ratings. The participants simply do not need to win the favour of investors. In addition, the new entrants might charge inflated fees because they would not need to compete. Thus, if we are concerned about encouraging factual verification and due diligence, the participants under this system would have little incentive to invest in costly research or conduct factual verification. Effectively, they might behave much like civil servants or tenured academics, placidly enjoying the quiet life.

Of course, the Board might instead choose the initial rating agency based on the CRA's prior record for accuracy. But this is easier said than done. A reliable track record for accuracy might take a decade or more to develop. New entrants would also have little prior experience upon which to rest any claim to demonstrated accuracy, and thus they would be prejudiced. In theory, the debt securities would have to repaid or redeemed before the full rating cycle was completed and the accuracy of the rating could be determined. If the board were to prefer established raters with a demonstrated history of rating accuracy, this would largely perpetuate the existing oligopoly of the Big Three and might subject the Board to criticism for failing to encourage greater competition. Hence, political pressures and Congressional expectations seem likely to compel the Board to favour either rotating assignments or some other technique that gave a substantial share of initial rating assignments to firms outside the Big Three.

Another problem might be the response of the Big Three to such a system. If the Big Three rating agencies elected to operate only as "issuer-paid" rating agencies and thus did not seek initial ratings from this Board, most of the initial raters would be relatively unknown raters whose opinions might not command much respect in the market. In short, there are risks that the initial raters would be both under-motivated and ignored, unless a more demanding selection criterion gave them greater credibility.

The second alternative – i.e., requiring institutions to obtain a credit rating from the rating agency of their choice (provided that it was not also paid by the issuer) – has the key advantage of encouraging greater competition. New rating firms would enter this market to compete for this business (probably on the accurate assumption that Moody's and S&P would remain committed to an "issuer pays" business model). Under such a "subscriber pays" system, the free rider problem would also diminish in its significance, because each substantial institutional investor would be required to hire a rating agency for its advice.[50] A market would thus be assured. Reputational capital would now count for something, and the rating agency might deliver a fuller report, not simply a two or three letter rating. Candidly, however, it must be recognised that investors are likely to resist having to pay themselves for a rating. Securities analysts have similarly found investors resistant to paying for investment advice. Although a "subscriber pays" model could be legally mandated, investors are likely to constitute a powerful political lobby against such a reform – at least so long as its costs fall on them.

Another danger in this model might be that some institutional investors would opt for the cheapest rating agency, which agency might in turn economise on its own efforts by simply conforming to the ratings provided by the "issuer paid" rating agency. Such "herding" is already common among both securities analysts and rating agencies.[51]

Given the political obstacles to imposing costs on investors, several possible variations can be imagined. One compromise would be to allow institutions to pass on the cost of ratings by seeking reimbursement of their rating fees from the issuer or deal arranger. At this point, the conflict of interest problem now re-enters by the back door (as underwriters might find ways to influence the choice of rating agency in return for agreeing to reimburse those costs). Reimbursement of the rating fee need not be prohibited, but its permissibility should be clearly conditioned on the investor having an unfettered right to choose its own rating agency.

Another bolder alternative, proposed by Grundfest and Hochenberg, envisions that any issuer who purchases an NRSRO rating must also pay for a second rating from an "Investor Owned and Controlled Rating Agency" (or an "IOCRA").[52] Again, this seeks to subsidise a "subscriber-based" market. Still, the incentive of investors to form such subsidiaries or collectives seems doubtful, in part because institutional investors are often in active competition with each other and thus do not share information freely.

Absent the unlikely formation of such investor-owned rating agencies, the simpler approach is to allow (or require) issuers to pay for a second rating from an investor-chosen rating agency. But here the critical complication involves how investors are to choose such a second rating agency, as the issuer cannot reasonably be expected to pay for the choice of each investor when this might require it to retain numerous rating agencies. One feasible answer to this problem would be to instruct the governmental board that selects the rater under the first option discussed above to poll institutional investors and select the rater preferred by the most institutions (possibly excluding the rating agency retained by the issuer). In effect, the Board would defer to the investors' choice. This would not permit every institution its individual choice, but it would still induce rating agencies to compete for the investors' favour. Now, the issuer could feasibly pay for the rating under this variant on the first alternative, but predictably better, or at least more attentive, services would be provided by rating agencies to investors under this approach.

Investors also have conflicts of interest that cannot be ignored. Some may choose a rating agency that gave inflated ratings in order to enable them to purchase risky securities with higher yields. In this light, an advantage of this last approach of an investor vote or poll is that it mitigates the danger that "fly by night" rating agencies would be chosen to deliver inflated ratings. Such a desire is plausible in individual cases because an NRSRO "investment grade" rating gives legal protection to the board and officers of a risk-

50 A significant legal difficulty arises, however, with proposals to mandate behaviour by investors. In general, the SEC and other securities regulators have no delegated power over investors as a group (but only selected institutions, such as mutual funds). Nor would it be politically easy to pass legislation requiring investors (or even institutional investors) to bear specified costs (such as the cost of a rating agency's rating).

51 See sources cited supra at note 30.

52 See Grundfest and Hochenberg, supra note 49.

preferring institutional investor in the event that a breach of fiduciary duty claim is raised against them following a costly default. A rating agency collectively chosen by a vote or poll of the institutions is thus preferable if we assume that the majority of institutions are prudent and only the minority are apt to behave as risk-preferrers.

The third option of the governmental rating agency raises the clearest dangers, for two distinct reasons. First, governmental agencies cannot pay the same salaries or incentive compensation to analysts as firms in the private sector, with the consequence that a “public” rating agency might have to rely on inferior personnel. Second and more importantly, serious doubt exists that a “public” rating agency could give a negative (or “junk”) rating to an important or politically-favoured local firm. Consider whether over the last decade a US “public” rating agency would have dared to rate the bonds of General Motors as “junk” (or non-investment grade). To be sure, the debt market might well have known that General Motors deserved such a low rating, but political outrage would have been predictably triggered if such a negative rating prevented a debt offering (or embarrassed public pension funds so that they declined to buy in G.M.’s debt offering). Congress could threaten to withhold further appropriations to such an agency unless its pessimism about the lowly-rated favoured firm were corrected.

This US example is probably mirrored by equivalent European examples (for example, could a German “public” ratings agency easily downgrade Deutsche Bank or Volkswagen?). Indeed, the European Commission’s interest in a European credit rating agency may have been triggered in part by the political outrage at the Big Three for downgrading Greece’s sovereign debt. Some non-European editorialists have already recognised this episode as a classic case of “blaming the messenger.”[53] The sad but simple truth is that politically accountable public bodies may find it more difficult to resist political pressure.

Nonetheless, even if a “Government Utility” rating agency is not a preferred option, little harm would follow from the addition of such an agency to the mix of opinions (if either the first or second option discussed above were selected). Also, a regional credit rating agency that was not subject to the control of any one country might be relatively less vulnerable to political pressure (although the example of the downgrading Greece’s debt suggests otherwise).

The one advantage of a Government Utility Approach is also a disadvantage of the “subscriber pays” model: those who do not pay are left in the dark by a “subscriber pays” model. Although this criticism has been raised by those sceptical of a “subscriber pays” model, the validity of this criticism probably depends on whether issuers and arrangers would continue to hire Moody’s and S&P to deliver “issuer paid” ratings. If they would, then the public would still have at least one publicly disclosed rating (which would likely be more accurate than today because of the competition from “private” ratings). In effect, no one is worse off under this system. Moreover, the need for public disclosure of ratings may depend on the extent of retail investor participation in the market, and generally retail investors simply do not participate in the market for structured finance products.

2.2.4 Reducing the Regulatory Power of Rating Agencies

Some believe that the basic error made by regulators was to grant ratings agencies a de facto regulatory role. In truth, this decision, which dates back to the 1930s in the US, was the product of the inability of financial regulators to define excessive risk themselves. Needing to prevent mutual funds, banks, investment banks, and pension funds and other collective investment vehicles from overinvesting in risky securities, US financial regulators either (1) required these institutions to limit their debt investments to securities having an “investment grade” credit rating (or at least to keep the majority of their portfolio in such securities) or (2) applied a stern “haircut” (or writedown) to financial investments not having such a

53 See Peter Hosking, “Brussels busy shooting the messenger,” The Australian, June 4, 2010, p. 28.

rating, thereby requiring investment and commercial banks to retain greater capital for regulatory purposes. Then, realising that financial institutions could outflank these rules by turning to new "fly-by-night" credit rating agencies, the SEC adopted rules in the mid-1970s that created a small, select club of "Nationally Recognised Statistical Rating Agencies" (or "NRSROs"). Because only the ratings issued by these NRSRO agencies were to be considered by regulators in determining the "investment grade" status of debt securities, this last step gave the Big Three de facto regulatory power.

In hindsight, the now ironic premise behind the SEC's reluctance to expand the number of NRSROs was that the Big Three were beyond capture. Until 2006, the SEC closely guarded its NRSRO designation and deliberately excluded most applicants seeking it (and those granted admission to the NRSRO club were often acquired by Moody's or S&P). Eventually, the passage of the Credit Rating Agency Reform Act in 2006 opened the doors of this club to new entrants. Although the economic barriers to entry remain high, there are today at least ten NRSROs, up significantly from the three firms that long dominated the field. But most of the new entrants occupy only specialised "niche" markets, and few, if any, rate structured finance products (for reasons discussed below).

Critics assert that the NRSRO designation (and similar requirements for investment grade ratings adopted as early as the mid-1930s by the Comptroller of the Currency) gave the credit rating agencies de facto licensing power and thereby compelled investors to rely upon them for regulatory permission. Clearly, this outcome was not intended, as federal regulators were simply following the path of least resistance. For them, it would have been a regulatory nightmare to attempt to adopt comprehensive standards of creditworthiness. But intent is less important than effect, and these critics argue that regulatory licensing power became the principal barrier to entry that excluded new entrants. This is a doubtful claim for several reasons: First, the Big Three also dominate European ratings where they enjoy no similar licensing power. Second, because Moody's and S&P dominated the field since early in the 20th Century, well before the creation of NRSROs and similar regulatory rules, the claim that their licensing power explains their market dominance cannot explain their market power before the time that they received any licensing power. Third, experience since 2006 shows that expanding the NRSRO club to ten firms has not eroded the dominance of the Big Three. Their supremacy thus seems more based on "first mover" advantages and the difficulty of entering the field without a proven track record. More likely, the initial firm to enter the field gains reputational capital over time, which creates a barrier to entry, If (as widely assumed) economies of scale characterise the production of financial information, the first entrant can operate more efficiently and exclude later entrants.

In this light, the more plausible hypothesis for the Big Three's dominance is that sophisticated institutional investors relied on Moody's and S&P because there was no one better to rely upon, even though they knew the conflicts latent in the "issuer-pays" model.[54] Still another possibility is that some institutional investors were actually content with rating inflation, as it allowed them to rationalise acquiring risky, but higher yield securities.

Based on the foregoing diagnosis, some reformers in the US (and the editorial pages of the Wall Street Journal) have insisted on reducing the de facto regulatory power accorded NRSRO rating agencies. An amendment to the pending federal financial reform legislation, which was sponsored by Senator George LeMieux (R-Flo.), passed the US Senate on May 14, 2010, with all Republican Senators (and many Democrats) voting for it. Incorporated into the final version of the Dodd-Frank Act, this provision

54 Economists have in fact developed such a model that assumes that some investors are "naïve" and others sophisticated. Under it, naïve investors take the ratings at face value, while sophisticated investors realize they are unable to determine the accuracy of the rating. They conclude that the reputational cost may be low in an oligopolistic market where all the major actors inflate their ratings. See Patrick Bolton, Xavier Friexas & Joel Shapiro, The Credit Rating Game (NBER Working Paper No. 14712 (2009)).

deletes references in several federal statutes governing financial regulators that require "investment grade" ratings from NRSRO rating agencies. Instead, it instructs these regulators to adopt their own "standards of credit-worthiness."

What will be the impact of this and similar provisions? Probably, they will have no more than marginal impact on the market position of the "Big Three" credit rating agencies – but for the fact that the current and pending federal financial statutes only seek to regulate NRSRO rating agencies. Thus, a possible strategic move for the Big Three may be to surrender their NRSRO status – and thereby avoid relatively demanding legislation that only applies to NRSROs. Indeed, the combined impact of the Franken Amendment and the LeMieux Amendment is to make the NRSRO status considerably more of a burden than a benefit for the Big Three. Under the Franken Amendment, by abandoning their NRSRO status, the Big Three would lose the ability to give the initial ratings to most "structured finance" issuers, but logically they might prefer to focus on marketing themselves to issuers as the providers of second opinions. Under the LeMieux Amendment, the Big Three will lose some of their so-called licensing power. Accordingly, when the burdens outweigh the benefits, it makes sense for them to abandon NRSRO status – if they can.[55]

The idea that reducing the regulatory power of the ratings agencies is the key to reform is popular in academia. The idea is simple, sweeping, and requires no understanding of the institutional or regulatory context. In reality, however, reducing the role of the rating agencies will likely be a slow and confused process. This has been shown by the early experience under the Dodd-Frank Act. The Act overruled a long-standing SEC rule (Rule 436(g))[56] that gave rating agencies an exemption from the liability that a statutory expert faces under Section 11 of the Securities Act of 1933. Under Section 11, an "expert" whose opinion is cited in a registration statement used in connection with a public offering of securities has presumptive liability for any material misstatement that it makes. Thus, if the stock price declines after the offering, the expert can be held liable for this price decline, unless it can prove that it was not negligent. The burden of proof is on the expert. Although this provision was principally intended to apply to auditors, the language of Section 11 clearly covers rating agencies as well, if the registration statement references their ratings. For many years, the SEC had effectively exempted rating agencies from Section 11 liability pursuant to Rule 436(g), which allowed the rating agencies to avoid consenting to becoming a statutory "expert." Dissatisfied with the rating agencies performance, Congress ended this exemption in the Dodd-Frank Act and expressly overrode Rule 436(g).

What happened? Predictably, the rating agencies refused to consent and thus blocked their ratings from being referenced in registration statements (as they were entitled to do). At this point, issuers discovered that, in the case of asset-backed securitisations, the SEC's rules required disclosure of the rating in the registration statement; thus, they could not comply without the rating agency's consent. As a result, some offerings could not go forward.[57]

55 A complicated legal issue surrounds whether existing NRSROs can deregister and in effect abandon their NRSRO license (now that it has reduced value). That issue is beyond the scope of this paper.

56 See 17 C.F.R. § 230.436(g). Technically, this rule permits the rating agency not to file a consent to the use of its rating in the prospectus. The significance of this elimination of its required consent is that an expert is liable under Section 11 only if it consents to be named as an expert in the registration statement.

57 See Anusha Shrivastava and Fawn Johnson, "SEC Breaks Impasse With Rating Firms," The Wall Street Journal, July 23, 2010 at C-1; Dennis Berman, "Note to Credit Raters: Evolve or Die," The Wall Street Journal, July 27, 2010 at C-1.

For a brief time, the public debt markets froze, and offerings were delayed. In response, the SEC declared a six month moratorium on its rule requiring the disclosure of ratings in the registration statement in the hope that a compromise could be negotiated.[58]

The message here is that reform needs to be incremental, because ratings are too deeply embedded in the debt offering process to be simply eliminated by the stroke of a pen. Whether rating agencies will continue their "strike" if it would cost them issuer business is uncertain, but negligence-based liability could conceivably cause them to withdraw from some markets. Similar problems will arise if money market funds are told that they may not rely on NRSRO "investment grade" ratings. Worried that they may face personal liability for an investment that goes sour, the boards of such funds have already fiercely resisted any deregulation that would deny them the ability to rely on investment grade ratings, and politically they are a potent force. This does not mean that deemphasis of credit ratings is wrong, but only that it will involve bruising political fights.

2.2.5 Encouraging Due Diligence

As noted earlier, rating agencies are unique among financial gatekeepers in not conducting factual verification. Obviously, factual verification would be costly, given the sheer volume of ratings that they issue. Still, there is an alternative to the rating agency doing its own factual verification: Rating agencies can instead require factual investigation by independent experts of the critical facts on which their models rely. As noted earlier, this had been the standard approach in rating structured finance products prior to 2000, as the investment banks and the rating agencies both relied on "due diligence" firms (such as Clayton Holdings and the Bohan Group) that were paid by the underwriters. However, as the housing bubble grew, investment banks cut off this flow of information, possibly because it might alert rating agencies to problems.

The pending financial reform legislation in the US takes several steps by which to restore due diligence. NRSRO agencies are, for example, required by the Dodd-Frank Act to disclose in a mandated form that must accompany the publication of each credit rating a variety of factual information, including:

> *"(v) whether and to what extent third party due diligence services have been used by the nationally recognised statistical rating organisation, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party."*[59]

This provision does not mandate factual verification, but it creates an embarrassment cost if due diligence services are not used. Also, under it, negative information discovered by the third party due diligence firm may have to be disclosed. Still, some rating agencies may find ways to rationalise their failure to use such a third party expert or to disclose some lesser alternative that they did use.

A stronger incentive for the use of due diligence is created by the liability provision of the Dodd-Frank Act. Section 933 ("State of Mind in Private Actions") addresses the scienter requirements for pleading an anti-fraud action (based presumably on Rule 10b-5) against a credit rating agency. It provides that in the case of an action brought against a credit rating agency or a controlling person thereof:

---

58 See "Statement by the SEC Staff: Statement Regarding the Registered Asset-Backed Securities Market" (July 22, 2010) (announcing a six months moratorium during which ratings need not be disclosed in the registration statement).

59 See Section 932(s)(v) of S.3217.

"[I]t shall be sufficient for purposes of pleading any required state of mind in relation to such action that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed – (1) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (2) to obtain reasonable verification of such factual information of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter."[60]

This language (which was drafted by this author) in effect says that the rating agency must either conduct its own "reasonable investigation" or rely on an "independent" due diligence firm. If the rating agency does not, then particularised factual pleadings of this failure will enable the plaintiff to survive the defendant's motion to dismiss. To be sure, the plaintiff would still have to show loss causation, reliance, scienter, and the other elements of a Rule 10b-5 cause of action,[61] but a strong incentive arises to use a third party due diligence firm in this setting.

In Europe, the litigation lever is both less favoured and less available as a means by which to influence the behaviour of market actors. Still, European regulators could simply mandate the use of a third party, "due diligence" firm to conduct factual verifications, at least in the case of structured finance offerings. Both in Europe and the US, the use of a third party due diligence firm is likely to be preferred by the rating agencies to any requirement that it conduct its own due diligence, both because (1) the cost of the third party firm's services can be directly passed on to the underwriters or deal arrangers, and (2) overlapping factual investigations by each rating agency are duplicative and inefficient. In a new and changed environment in which multiple rating agencies are likely to rate the same security, use of a third party expert spares society the costly and senseless duplication of requiring each rating agency to conduct a separate investigation of the same facts. Any such report provided by a third party expert should presumably fall within the earlier discussed "equal access" rule and so be accessible to all rating agencies.

2.2.6 Increasing Competition

The creation of a Credit Agency Review Board (as the Franken Amendment would mandate) may encourage some new entrants to become NRSRO rating agencies, and, even more likely, it may encourage some "niche" firms that are already NRSROs to extend the zone within which they rate securities. But this amendment does not seem likely by itself to produce greater competition based on quality of services or price. To be sure, if the Board used relative accuracy as its basis for choice, this might eventually produce competition for greater accuracy, but only after an extended transitional period. A reliable and measurable reputation for accuracy would probably take a decade or more to develop, particularly for new entrants.

A quicker route to robust competition might be to require institutional investors to obtain their own credit rating from an approved "subscriber pays" rating agency. This would subsidise a new market, without requiring the government to choose the rater. Nor could a "fly by night" rater that was ready to give inflated ratings to institutions desiring such ratings easily enter this market if the institutional investor were required to choose an NRSRO rating agency that met minimum governmental standards.

60 See Section 933(b)(1)(B) of S.3217.

61 Potentially, the complete failure to conduct any factual due diligence or to receive seemingly reliable reports from independent third parties may show a reckless indifference to factual accuracy that also can demonstrate scienter, but this will depend on the facts and circumstances of individual cases.

Another sensible reform that seeks to encourage competition is the "equal access" rule. It is a response to the complaints raised by the few "subscriber pays" rating agencies that issuers will not give them access to the material facts about their deals. From the issuer's perspective, it does not need to hire every available credit rating agency, and many issuers may regard the few existing "subscriber pays" rating agencies as unwelcome nuisances because they arguably have an incentive to distinguish themselves by giving lower ratings than the Big Three. As a result, issuers had generally declined to release confidential data to them, and, particularly in the field of structured finance, this chilled competition.

In response, the SEC has adopted Rule 17g-5, and Congress will similarly and more generally mandate "equal access" in its pending legislation. The EU Commission's proposed rules take a similar approach. Issues, however, remain. The SEC's rule requires the retained rating agency to release all data to other NRSRO agencies that request it, but does not require public disclosure. Under pending SEC rules, this data might be stored in a confidential, password-protected website to which requesting NRSRO agencies would be given access. Whatever the details, "equal access" seems a necessary precondition to greater competition.

2.2.7 Staleness Reforms

Much criticism has pointed out that rating agencies are slow to update their ratings or to downgrade them. One reason for this tendency is economic: there is today little, if any, revenue in downgrading a client's rating and some risk of a loss of future business. One relevant response to this problem would be to require the issuer to enter into a multi-year contract with the rating agency to monitor the issuer's rating for a defined period after a rating's issuance. This pattern is already beginning to develop, but should be mandated. The issuer would be required to pay a "reasonable" annual fee for this service. If the initial rater were picked by a neutral body (such as the Credit Rating Agency Review Board), this reform seems promising. If not, a conflicted, "issuer-paid" rating firm will probably still be slow to downgrade.

Were the issuer to default on these annual monitoring payments, regulations might provide that the initial rating would have to be immediately withdrawn with a prominent notation made on the rating agency's web site (this would be substantially equivalent to an auditor withdrawing its audit opinion, which is a well known "red flag").

2.2.8 Internal Governance

An obvious (and politically irresistible) approach toward reform of the credit rating agencies is to regulate their internal corporate governance. Section 932 of the pending Senate Bill does this in a variety of ways. It would amend Section 15E of the Securities Exchange Act of 1934 to require NRSRO rating agencies to:

- "establish, maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings;"
- submit to the SEC an annual internal control report;
- separate the rating function from sales and marketing activities;
- appoint a compliance officer with specified duties; and
- provide additional disclosure with each rating, setting forth the details of its methodology and the data relied upon.

Many of these provisions seem to have been borrowed from the 2002 global settlement reached by the SEC, the New York State Attorney General, the NASD and other agencies with the securities industry regarding securities analysts. Debate continues over how effective that settlement has been, and the SEC recently (and unsuccessfully) attempted to drop as unnecessary some of the provisions in that settlement that precluded communications between analysts and investment bankers. Although there is evidence that senior executives at rating agencies placed pressure on their analysts, it is not clear that the provisions of Section 932 will stop this.

In general, many of these corporate governance reforms were already in place at investment banks, such as Bear Stearns, Lehman, and Merrill Lynch, and there is little evidence that they worked to bring adverse information to the attention of those boards. Compliance officers, for example, are required at all broker-dealer firms and will be required by SEC rules at all NRSRO rating agencies.

From a policy perspective, it is difficult to place great hope on these reforms, but they are low cost reforms that may sometimes provide valuable information to experienced regulators.

2.2.9 Administrative Registration

Consensus exists in both the US and Europe that credit rating agencies should be registered with a government agency and subjected to its continuing oversight. To this extent, reliance on self-regulation and voluntary codes of conduct has been abandoned in Europe. In the US, pending legislation will create a new office within the SEC – the "Office of Credit Ratings" – to oversee credit rating agencies; it also requires annual oversight of their internal controls and the consistency of their methodologies.[62] Sceptics have doubted the efficacy of such efforts, because governmental agencies have little expertise in evaluating credit risk (and the SEC in particular has far less expertise in this area than do bank regulators, such as the FDIC and the Federal Reserve). Some fear that the tendency of bureaucratic regulators might be simply to focus on procedural regularity by the rating agency: Did it keep full and complete records?; Did it have a compliance officer; etc.?

Still, empirical research, such as that earlier noted by Griffin and Tang,[63] has identified a strange pattern of discretionary upward adjustments that inflated the size of AAA-rated tranches in structured finance offerings. This is the type of pattern on which regulatory oversight should properly focus. Indeed, the SEC has begun to respond. In 2009, SEC Rule 17g-2(a)(2) was amended to require NRSROs (in the case only of structured finance products) to document the reasons for a deviation when a final credit rating materially deviates from the rating implied by the NRSRO's quantitative model.[64] Europe needs to adopt a similar rule, because it should be a priority for regulators on both sides of the Atlantic to monitor deviations by rating agencies from their quantitative valuation models and demand detailed justifications.

3. Conclusion

The Good. Both in the US and Europe, steps are being taken to reduce the conflicts of interest in which credit rating agencies are virtually embedded. But these steps are piecemeal and incomplete. Three simple truths need to be recognised:

First, an "issuer pays" business model invites the sacrifice of reputational capital in return for high current revenues.

62 Most of these provisions are in Section 932 of S.3217 (the Senate Bill).

63 See text and notes supra at notes 13 to 17.

64 See 17 C.F.R. Sec. 240.17(g)-2(a)(2). Technically, this rule applies only when a quantitative model is a "substantial component" of the rating process.

Second, competition is good, except when it is bad. When CRAs compete for the favour of issuers, rather than for that of investors, ratings arbitrage results. Both in their indifference to "red flags" and their tolerance for "thin" subordination, the CRAs appear to have engaged in a continuing race to the bottom.

Third, in a bubbly market, no one, including investors, may have a strong interest in learning the truth. The process of ratings inflation continues until the short sellers realise that enormous profits can be made from betting against inflated ratings. Only a strong and highly motivated watchdog can offset this process of repression and self-delusion.

From this perspective, neither the SEC nor the European Commission has yet taken a significant step that is likely to spur the creation of a "subscriber pays" market for credit information. At most, the SEC and the EU Commission have endorsed an "equal access" rule that, if enforced, would preclude the most blatant form of issuer hostility to a "subscriber pays" model. But useful as the SEC's Rule 17g-5 is, it is insufficient to jumpstart a "subscriber pays" market into existence. Instead, what is needed are incentives. Appropriate incentives could be created in a variety of ways. Rules could require investors or deal arrangers to obtain a second rating from a CRA selected by investors. In the United States, the Franken Amendment (whose ultimate fate must await a two year study by the SEC) does take an initial, but imperfect, step in this direction by severing the connection between issuer payment and issuer selection of the CRA. But the problem with the Franken Amendment is that it does nothing to encourage competition among CRAs for the favour of investors (and thus to incentivise CRAs to conduct independent research or verification). If, however, the initial rater were chosen through a vote (or even a poll) of likely investors, then the nature of the competition would change, and the CRAs would need to compete for the favour of investors.

The Bad. The major alternative to administrative oversight is deregulation, which would be achieved by eliminating existing requirements for credit ratings. Although it would be desirable to make investors less reliant on credit ratings, it is doubtful that this can (or should) be achieved by a stroke of the statutory pen. Rapid deregulation will likely produce a few failures at money market funds and other sensitive financial institutions and the appearance of some "fly by night" rating agencies. Equally important, it is necessary to recognise that credit rating agencies can play a socially useful and economically efficient role as informational intermediaries.[65] They can do so precisely because specialisation is efficient. Because structured finance products are complex and opaque and because the rate of innovation in the field is rapid, "do-it-yourself" credit analysis by even sophisticated institutional investors will be inefficient. Economies of scale characterise the production of financial information, and thus even a large institutional investor, if diversified, will not have the same broad range of expertise that a properly motivated CRA should have.

Moreover, even if large institutional investors could assemble similar expertise in-house, such an investment in an in-house capacity is essentially duplicative, as all these institutions are essentially investing in the acquisition of similar information which they could more cheaply purchase from specialised firms. For these reasons, any campaign to abolish credit rating agencies or discourage their use would be misguided.

Nor is it realistic to attribute the dominance of the Big Three to their de facto regulatory licensing power. Their market dominance preceded the SEC's creation of NRSROs, characterises Europe as well in the absence of any similar regulatory power, and has persisted in the US even after the Credit Agency Reform Act of 2006, which effectively ended any legal basis for their predominance. Their oligopolistic position seems attributable instead to the high barriers to entry into this market, which require that a new firm acquire reputational capital before it can acquire clients. This is the critical "Catch 22" problem that impedes competition.

---

65 Empirical studies have documented the informational value of credit ratings and shown them to be independent of and additive to the informational value that can be derived from credit default swap prices. See Lars Norden & Martin Weber, The Comovement of Credit Default Swap, Bond and Stock Markets: An Empirical Analysis, (available at http://ssrn.com/abstract=635981 (2004)).

The Ugly. Worse yet, there is also a dark side to reform, as the creation of a governmental rating agency presents special dangers. Not only might such an agency be conflicted, but there is a more ominous danger that if private CRAs disagree with its rating analysis, the regulator might take their disagreement as evidence of a deficiency in the procedures or methodologies of the non-governmental CRAs. As anger against the CRAs mounts, the prospect of retaliation for politically incorrect ratings lurks in the background. Ironically, while the CRAs have been justly criticised in the US for inflated ratings, they may face even greater hostility in Europe for downgrades that are perceived as excessive or premature.

The Prescription. How much regulation is needed? If the market incentivised CRAs to compete for the favour of investors, less regulation and oversight would be required. However, in the absence of such incentives, close regulatory oversight is needed. On what should such oversight focus? The empirical research has identified a pattern of discretionary adjustments that CRAs made to inflate their ratings. Unfortunately, the tendency of a bureaucratic regulator is more to focus on procedural regularity, record-keeping, and adequate staffing. Such procedurally-oriented bureaucratic oversight promises little benefit. Instead, upward adjustments and deviations from the CRA's normal valuation model should be the regulatory focus.

Precisely because the term "oversight" is vague and regulatory supervision can sometimes degenerate into bureaucratic nitpicking (or worse), a clear regulatory agenda needs to be specified for the new ESMA in its oversight of CRAs in Europe. As just noted, the first priority should be to focus on upward deviations or adjustments from the CRA's methodology, which methodology must be publicly disclosed, at least in the case of issuer-paid CRAs.[66] Briefly, ESMA's priorities should include:

- implementation of a detailed "equal access" rule;
- requiring multi-year fee contracts between the issuer and a rating agency hired or paid by the issuer so that follow-up monitoring of the initial rating is required;
- a corresponding requirement that when a CRA changes its methodology, it must revise all existing ratings that would have been originally affected by that change within a defined period;
- the development of a publicly available ratings history for each CRA, enabling investors to see the subsequent history of its ratings, including all defaults and downgrades;[67]
- prohibition of certain clear conflicts of interest, including rating offerings on which the CRA consulted (i.e., "self-rating");[68]
- a rule requiring the disclosure of any "preliminary" ratings to discourage rating shopping; and
- encouraging the use of third party "due diligence" firms to assure factual verification.

---

66 As just discussed, SEC Rule 17g-2(a)(2), adopted only in 2009, requires NRSROs to document the reasons for a deviation from their quantitative valuation models. See text and note supra at note 64. SEC Rule 17g-1 also requires public disclosure by the CRA of the methodology that it uses to determine ratings, and such disclosure must be sufficiently detailed to provide users of the ratings with a clear understanding of the process used by the NRSRO.

67 SEC Rule 17g-2 already requires such rating histories to a limited extent. Under it, the CRA must disclose 10% of the ratings, chosen at random, for each class of ratings in which the NRSRO rating agency participated. Under a 2009 amendment to this rule, the 10% requirement increases to 100% for ratings issued after June 26, 2007. See 17 C.F.R. Section 240.17g-2 (2009).

68 SEC Rule 17g-5 precludes an NRSRO issuer from issuing or maintaining a credit rating with respect to an issuer or obligor where it (or any associated person) "made recommendations . . . about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security." See SEC Rule 17g-5(c)(5). See 17 C.F.R. Section 240.17g-5(c)(5) (2009).

Much is changing. In this flux, the optimist will see a growing consensus that closer regulation is both needed and gaining political support. The pessimist will sense instead that regulators may increasingly ready to punish CRAs for politically sensitive ratings downgrades (either of a locally favoured company or a sovereign debt where the effect is to destabilise the market or a currency). The practice of “blaming the messenger” for bad news is a tradition that has persisted for millennia. Unacceptable as the performance of the CRAs has been, the future could see them caught between Scylla and Charybdis: sued by investors in the United States for inflated ratings and disciplined by politically-motivated regulators in Europe for downgrades that destabilise markets or disfavour politically powerful local companies.

Amidst all this change, one priority must be insisted upon: the failure to address the “issuer pays” business model, while addressing only more specific conflicts (such as those addressed by the “equal access” rule), amounts to re-arranging the deck chairs on the Titanic, while ignoring the gaping hole created by the iceberg. On both sides of the Atlantic, there should be a recognition that (1) the existing market for ratings failed, (2) voluntary self-regulation and reliance on the rating agency’s desire to protect its “reputational capital” is inadequate, and (3) incentives must be aligned so that the watchdog is motivated to watch carefully.

Although regulatory supervision can mitigate conflicts of interest, the intensity of such supervision always eases once “boom” times arrive again, and thus the cycle leads back to laxity. Because of the inevitability of this sine curve of regulatory intensity, the sounder course is to encourage a “subscriber pays” model that can compete with the “issuer pays” model. But because of the “public goods” nature of financial information, a “subscriber pays” (or “platform pays”) model will not arrive naturally, and regulatory interventions are necessary to prod it into existence. If we get the incentives right, relatively little regulation is needed. But if the incentives remain poorly aligned, it is unclear whether any level of regulation can ensure ratings accuracy.

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.

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 mid-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.

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.

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

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 4/5th 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

1 This paper was initially prepared for the meeting of the Competition Committee of the OECD, Paris, 16 June 2010. Comments from participants of the meeting are gratefully acknowledged, as well as from Piero Cinquegrana, Chris Lake, Barbara Matthews and Diego Valiante.

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 by far 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.

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 million $		**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.

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. In effect, financial markets are constantly affected by adverse selection mechanisms and investors need third party tools as credit ratings in order to reduce asymmetric information and increase their ability to understand the real risk of financial instruments.

As there had not been much of a capital market in Europe until recently, banks have essentially performed the credit risk analysis function, and continue to do so. But the credit risk analysis function of European banks declined, possibly as a result of the reputational strength of the US capital market model.

The introduction of the euro and a set of EU regulatory measures led a rapid development of European capital markets, and demand for ratings. Moreover, European authorities created a captive market for an essentially US-based industry.

2. A European captive market for CRAs

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, respectively the threshold and haircut for the ECB's liquidity providing operations. Neither is the case in the US, as it has not implemented Basel II (largely because because the Federal Reserve did not want to have the vast majority of US banks relying on CRAs for setting regulatory risk weights), and the discount window of the Fed is not based upon ratings. The Dodd-Frank Act (June 2010) goes even further, and requires regulators to remove from their rules any references to "investment grade" and "credit ratings" of securities[2].

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. The reliance on ratings agents nor the risk weightings have been changed in the Basel III proposals, which were published on 12 September 2010.

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.

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 (ECAIs). 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.[3] The minimum credit quality threshold is defined in terms of a 'single A' credit assessment,[4] which was temporarily relaxed during the financial crisis to BBB-. 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.[5]

2 Clifford Chance (2010), p. 73.

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

4 "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.

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

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.[6] 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 (RMBS) form the most important element, exceeding 50%. These securitisation instruments, and in particular the residential mortgage-backed securities segment, were an extremely important market for CRAs. Moody's, for example, assigned the AAA rating to 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.[7]

3. The EU rating agencies regulation

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.[8] 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 in national law.

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.[9]

In 2006, the CESR, in a report for the EU Commission, concluded that the ratings agents largely complied with the IOSCO Code.[10] 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.

Notwithstanding CESR advice, the EU Commission went ahead and issued a proposal in November 2008, after two consultations in July and September 2008. The EU regulation:

- requires CRAs to be registered and subjects them to ongoing supervision;
- defines the business of the issuing of credit ratings;

---

6 The liquidity categories were changed in September 2008 and the valuation haircuts increased in July 2010. See latest changes to risk control measures in Eurosystem credit operations, European Central Bank, Press notices, 4 September 2008. and 28 July 2010.

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

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

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

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

- sets tight governance (board structure and outsourcing), operational (employee independence and rotation, compensation, prohibition of insider trading, record keeping) and conduct of business (prohibition of conflicts of interest in the exercise of ratings or through the provision of ancillary services to the rated entity) rules for CRAs;
- requires CRAs to disclose potential conflicts of interest and its largest client base;
- requires CRAs to disclose their methodologies, models and rating assumptions. CESR is mandated to set standards for methodologies and establish a central repository with the historical performance data.

The regulation came into force 20 days after its publication in the official journal, this is 7 December 2009. But guidance had 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.

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-empted its transformation in a securities market *authority* under the proposals discussed as further to the de Larosière report.

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 issued 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 have to be endorsed by the CRA registered in the EU, subject to a series of conditions (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. EU financial institutions will invest less abroad, as the ratings on third country investments may be seen to be of insufficient quality, unless they are endorsed in the EU, or their rating agents are equivalent. 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).

The amendments the EU Commission tabled 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.[11] The ESMA would become the sole supervisor, for the sake of efficiency and consistency, doing away with the complex system described above. National supervisors will however remain responsible for the supervision of the use of credit ratings by financial institutions, and can request ESMA to withdraw a licence. ESMA can ask the European Commission to impose fines for non-respect of provisions of the

[11] 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.

regulations (see Annex III). ESMA may also delegate specific supervisory tasks to national authorities. The proposal does however not propose any involvement of the European Systemic Risk Board (ESRB), which could have been useful in the control of the methodologies and the macro-economic models used by CRAs. The draft regulation finally requires issuers of structured finance instruments to disclose the same information which they have given to the CRA, as is the case under the US SEC's Rule 17g-5. This change was welcomed by the markets as it would make both regimes convergent.

The Dodd-Frank Bill and CRA's

The new EU regime for CRA's is very close to the new US regime, as introduced by the Dodd-Frank Bill. Whereas the US had already legislated the sector in 2006 in the Credit Rating Agency Reform Act, this was a light regime imposing a registration with the SEC as Nationally Recognized Statistical Rating Organization (NRSRO). The Dodd-Frank Bill fundamentally alters this regime by requiring tight operational (internal controls, conflicts of interest, qualification standards for credit rating analysts) and governance requirements, and detailed disclosure requirements (including disclosure of the methodologies used). The SEC is required to create an "Office of Credit Ratings" to implement the measures of the Bill, to issue penalties and to conduct annual examinations and reports.

Source: Clifford Chance (2010).

4. The regulatory debate

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 potential 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.

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 by banks. It creates the illusion that the industry will live to the new rules, and that this will adequately supervised.

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. Pagano does however not discuss how to deal with free riding. 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, (see Annex I, Section E), but it is questionable whether investors will read this. On the contrary, given that a supervisory *fiat* has been given, investors may be even less inclined to read all the information, as was demonstrated during the financial crisis.

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.

Ponce (2009) discusses an interesting alternative to the issuer-pays model: the platform-pays model. He demonstrates on the basis of large data sets 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 rating agency may choose a quality standard below the socially efficient level. In this case, Ponce argues, a rating 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. The problem with this model however is its governance, which will need to be watertight.

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 entrance in the market and ratings levels, without exception.

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.

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. The downside of the partnership model is however the liability problem, which may deter many from being active in that business.

During the sovereign debt crisis, European and national policy makers have repeatedly raised the possibility of 'creating' local CRAs, eventually government sponsored. A state controlled CRA would lack independence, and hence credibility, and, as demonstrated above, it is not necessarily more competition that will solve the problem.

5. Conclusion

Considering the policy alternatives outlined above, the EU and the US should probably have considered the specificities of the sector more carefully before embarking upon legislation. The legislation that was adopted does not alter the business model 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.

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.

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.

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 or hardly 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 checking their compliance with EU Treaty rules on concerted practices and abuse of dominant position, which may raise some feathers.

REFERENCES

Arbak, Emrah and Piero Cinquegrana (2008), Report of the CEPS-ECMI Joint Workshop on The Reform of Credit Rating Agencies, November, available from www.eurocapitalmarkets.org

Becker, Bo and Todd Milbourn (2009), *Reputation and competition: evidence from the credit rating industry*, Harvard Business School, Working Paper No. 09-051.

Black, Bernard S. (2001), The legal and institutional preconditions for strong securities markets, *UCLA Law Review*, Vol. 48, pp. 781-855.

European Commission (2008), Commission staff working document accompanying the proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies – Impact assessment, SEC/2008/2746 final, November.

European Commission (2010), Proposal for a regulation of the European Parliament and the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies, June.

Cinquegrana, Piero (2009), *The Reform of the Credit Rating Agencies: A Comparative Perspective*, ECMI Policy Brief, February, available from www.eurocapitalmarkets.org

Clifford Chance (2010), Dodd-Frank Wall Street Reform and Consumer Protection Act, June 2010.

Coffee, John (2010), Ratings Reform: A Policy Primer on Proposed, Pending and Possible Credit Rating Reforms, Paper presented at the OECD Competition Committee, June 16th, mimeo.

Fitch (2010), "The Role of the ECB –Temporary Prop or Structural Underpinning?", 11 May.

Harris, Larry (2010), "Pay the rating agencies according to results", *Financial Times*, 4 June.

Pagano, Marco and Paolo Volpin (2009), *Credit Ratings Failures: Causes and Policy Options*, mimeo.

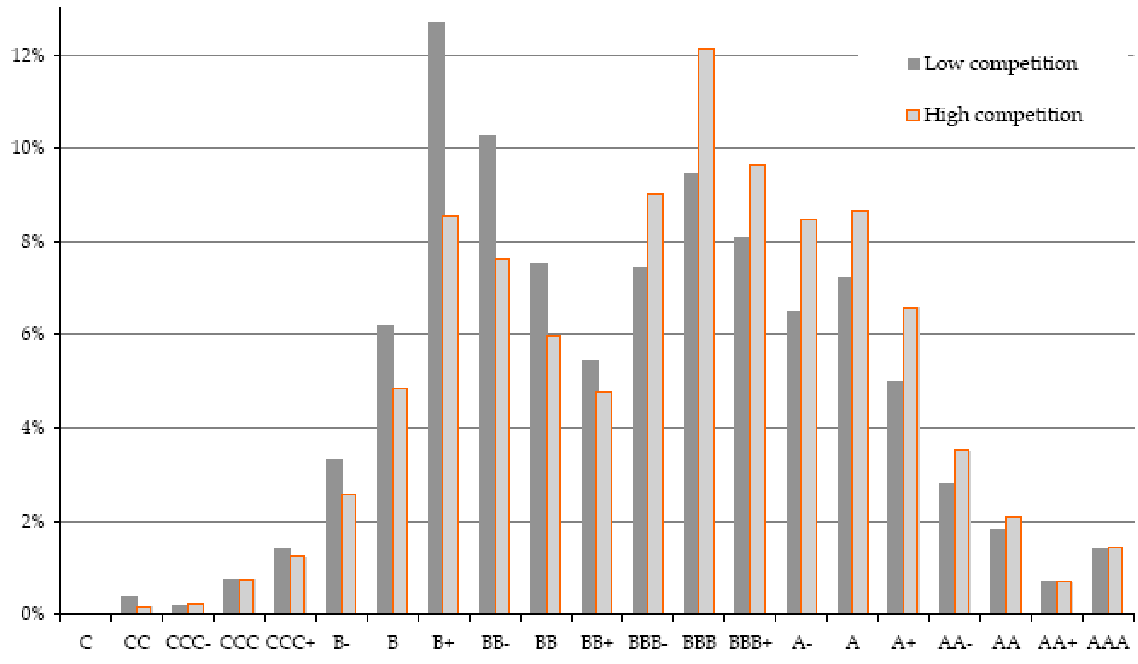
Ponce, Jorge (2009), *The Quality of Credit Ratings: A Two-Sided Market Perspective*, mimeo, August.

Richardson, Matthew and Lawrence J. White (2009), The Rating Agencies: Is Regulation the Answer? In Acharya, Viral V. and Matthew Richardson (eds.) (2009), Restoring Financial Stability, New York: Wiley.

St. Charles, Christina (2010), Regulatory Imperialism: The Worldwide Export of European Regulatory Principles on Credit Rating Agencies, forthcoming, Minnesota Journal of International Law, Summer.

Figure 2.

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



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