

Credit Rating Agencies (CRAs) and European Regulation

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1. A PREMISE

In the policy debate ignited by the current financial crisis, CRAs are quite at the centre of the regulatory agenda. They are often blamed for having failed to properly exert their gatekeeper's role and are indicated therefore as one of the main causes of the recently burst bubble. It is widely believed, in particular, that they did not properly assess the systemic risk when granting their ratings to the securities issued by a Special Purpose Vehicle (SPV). Due to the importance of credit risk repackaging in the originate to distribute model, and the correlated relevance (both from a regulatory and market perspective) of the ratings granted by CRAs, this failure deeply affected the proper functioning of the market. Since CRAs were unregulated entities and the current crisis seems to show a clear case of market failure, a regulatory response was quite obvious. The United States stepped in first. The European Union is now going to join. We will briefly discuss here the features of the proposed EU legislation.

2. AN OVERVIEW OF THE EUROPEAN PROPOSAL AGAINST THE BACKDROP OF RECOGNIZED MARKET FAILURES AND OF THE SELF-REGULATORY AND US INITIATIVES ALREADY IN PLACE

The proposal for a regulation of the European Parliament and of the Council on CRAs delivered by the Commission on 12 November 2008 (COM(2008) 704 final), drawing lessons from the recent financial crisis, acknowledges that CRAs play an important role in evaluating and disseminating information on financial products, including structured credit products, and that many retail and qualified investors relied heavily on their ratings for their investment decisions. Indeed, ratings distil complex financial information into easy to use symbols and ranking and are widely used as an often decisive factor in the investment decision. The proposal acknowledges moreover that, as indicated by the Financial Stability Forum report of April 2008, 'poor credit assessments by CRAs contributed both to the build up to and the unfolding of recent events'. It is generally accepted, indeed, that if the current crisis tells us anything, it is that CRAs, despite the fact

that they had demonstrated for roughly a century their ability to (quite) accurately predict defaults on corporate bonds, failed to do so for structured finance products. In this respect, as Professor Coffee Jr. recently wrote (2008), 'possibly their greatest deficiency was their blindness to the default dependence among the similar assets in the portfolio. The possibility of default contagion in real estate markets. Besides overlooking contagion risk, the rating agencies erred in at least two other important ways. First, the investment grade status given to senior tranches of Collateralized debt obligations (CDOs) was largely based on the subordination of junior tranches. But the rating agencies appear to have seriously underestimated how much of the portfolio had to be placed in the junior tranche and subordinated to adequately secure the senior tranche. Secondly, the rating agencies relied much too confidently on credit enhancement provided by monoline insurers'. Professor Coffee correctly adds that 'the basic picture that emerges is one in which: (1) the rating agencies were using largely untested quantitative models that were very different from the judgment-based methodologies that they used to assess default risk at individual issuers; (2) the rating agencies were tardy in their response to new information of which they were aware; (3) they relied on untested, unverified factual information submitted by loan originators who knew how to influence the agencies' models and had considerable incentive to do so by withholding adverse information'. It should be remembered that, in times of structured finance, rating is a repeated game: the investment bank is the key player and 'it may have packaged together a different CDO offering on a nearly monthly basis during 2005 and 2006'. The ability of CRAs to 'simply say no' to such clients lessened substantially over time, thereby dramatically affecting the accuracy of their output. Moreover CRAs operate in an oligopolistic market that offers limited incentives to compete on the quality of the rating produced. In light of these market failures, CRAs have been subject to regulation and SEC supervision in the US since 27 June 2007 (when the US CRA Reform 2006 entered into force), 'to improve ratings quality for the protection of investors and in the public interest by fostering accountability,

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transparency and competition in the CRA industry'. Since most of the existing CRAs are primarily based in the US, this reform deeply influenced the market and partially pre-empted any subsequent regulatory intervention in Europe and elsewhere. The Commission Impact Assessment (SEC (2008) 2745) shows at page 104 ff. a useful comparative table of the Commission proposal and of US rules. Meanwhile, the International Organization of Securities Commissioners (IOSCO) code of conduct, originally published in December 2004, was revised in May 2008: these revised rules are considered by the current proposal for a European regulation as 'the global benchmark'. However, these principles are subject to a 'comply or explain' rule and, according to the Commission, 'need to be concretized and consolidated in some cases to make them easier to apply in practice and more efficient'. This was precisely the exercise made by the Commission with its proposal. Furthermore, in 2007 and 2008 all major CRAs started to undertake, individually and collectively, a series of actions to upgrade their internal governance and operational practices to enhance the rating process, the management of conflict of interests and the information they provide on rating methodologies and the meanings and limitations of ratings. These steps were welcomed by policy makers but, in turn, were considered not enough to exclude further action also by EU institutions: the Financial Stability Forum and the European Parliament (with the Rasmussen and Van den Burg own initiative reports) called for a strong European legislative initiative. The Commission agreed. In fact, in the words of the Commission after the emergence of the financial crisis, 'self-regulation based on voluntary compliance with the IOSCO code does not appear to offer an adequate, reliable solution to the structural deficiencies of the business. While the industry has come up with several schemes for self-regulation, most of these have not been robust and/or stringent enough to cope with the severe problems and restore the confidence in the market'. Regulation in the field is not completely unprecedented in Europe: at least in the banking sector, specific requirements for recognized rating agencies (ECAI – External Credit Assessment Institutions) were already part of the risk management provisions of CRD implementing Basle II (2006/48/EC) and CEBS had already issued detailed guidelines on the recognition of ECAIs. The Commission proposal for a regulation on CRAs sets out that banks, insurances, pension funds, UCITs 'may only use for regulatory purposes credit ratings which are issued by CRAs established in the Community and registered in accordance with this Regulation' (Article 4). This means that, although it is not completely clear what sanction would apply in case of violation of this provision, in principle CRAs must be established in Europe (see also recital 27, requiring CRAs having their headquarters outside the Community to set up a subsidiary in Europe) and would receive formal authorization from the home country supervisor – that is that of the country in which the CRA has its registered office; this, however, through a centralized single entry point: the Committee of European Securities Regulators (CESR), which would act 'as one

stop shop for applications and a central point for informing and coordinating all EU national regulators'. The draft regulation sets out moreover corporate governance rules (e.g. on the appointment of at least three non executive independent directors) and tight operational requirements (e.g. on rotation mechanism for analysts, on rating methodologies and their validation based on historical data – expressly providing that 'in cases where the lack of reliable data or the complexity of the structure of a new type, in particular structured finance instruments, raises serious questions as to whether the CRA can produce a credible credit rating, the CRA should refrain from issuing a credit rating or withdraw an existing credit rating' – on the control of the reliability of the information used to rating purposes), rules on the avoidance of conflict of interests, on the use of different rating categories for bonds and structured finance instruments, on the disclosure of methodologies, models and key assumptions used for the rating, so as to allow sophisticated market participants to check the soundness of the methodologies and the reliability of the rating.

3. THE INNOVATIVE SUPERVISORY ARRANGEMENTS CENTRED ON CESR. A FEW INSTITUTIONAL REMARKS AND A CALL FOR A LESS TIMID APPROACH ON THE REFORM OF THE SUPERVISORY ARCHITECTURE

The proposed regulation is, in my view, to be welcomed. It brings about a common European regulatory framework based on quite the same principles applied in the US; at the same time, it goes even further than current US and IOSCO principles in setting more detailed rules, possibly taking the lead at the international level in setting out stricter rules. International convergence and regulatory competition (of the 'race to the top' kind, though) are both at work here. By requiring CRAs operating globally to qualify in Europe to access the European market, the draft regulation signals a strong commitment to defend European investors. Some contend (Lannoo, 2008) that, due to this requirement, 'CRAs may choose not to be active in the EU any longer or reduce their presence in the EU'; but, to my mind, this is a very unlikely outcome. Big players will be simply forced to abide by the strictest rules. The innovative proposal on supervision deserves however closer scrutiny. The idea of a 'single entry point' for the qualification of CRAs to operate across Europe is right and confirms that, also in this domain, a supervisory architecture fragmented along national boundaries would be inadequate. Ratings are produced in a Member State but tend to be used in the pan-European financial market by investors scattered throughout Europe. The same reasons underpinning the adoption in this context of a regulation are conducive to a centralized European supervisory architecture for CRAs. However, the solution adopted by the proposal, whilst stretching the mandate of the CESR, does not reach the point of creating a single community agency. This compromise – certainly influenced by concerns on the need for a Treaty amendment for the establishment of a new central supervisory authority at the EU level – might prove however too timid. In my

view, the time has come to move swiftly towards a single community agency. It is difficult to see a better opportunity than this to make a first step in this direction. Indeed, path dependency and concerns on the need for a Treaty amendment prevented up to now the adoption of a European centralized supervisory architecture for financial intermediaries traditionally regulated at the national level. Such path dependency plays no role in respect to CRAs, that are going to be regulated 'from scratch' at the European level and, up to now, were almost unregulated at the Member State level. In turn, the international character of the rating industry facilitates the attribution of the supervisory function to a centralized European body. The crisis clearly showed that mistaken ratings, regardless of where they were originated, had spill-over effects and raised significant cross-border negative externalities which significantly contributed to undermine the financial stability of the area. To properly address such externalities supervisory decisions need to be taken, if not globally, at least at the European level. Thus, it does not make much sense, in my view, acknowledging, as the Commission does, that the existing market failures must be addressed through a regulation in order to avoid regulatory competition, but at the same time avoiding addressing the risk of supervisory competition in laxity. One of the clear lessons of the current crisis is that 'national supervisory authorities have an implicit task, that of defending and promoting their national industry within an integrated international financial market. To some extent, this puts supervisory authorities in competition among themselves, which affects their regulatory and oversight tasks'.¹ In other words, the application of the home country control principle seems to me quite inappropriate in this context; and even more so, if we consider that most of the (few) rating agencies are based outside the EU and would be forced to set up a subsidiary in Europe by the regulation. Why should we offer a leeway for supervisory arbitrage when we get the chance to regulate, and supervise from scratch at the European level, an industry currently unregulated and unsupervised at national level? One could argue that the coordination role given by the regulation to CESR would suffice to avoid supervisory competition in laxity. I disagree. CESR powers are not binding and, despite its best efforts to promote convergence, the conferral of the decision-making to the home country supervisor inevitably promotes, in due course, diverging supervisory styles and practices. This could exacerbate conflicts between home country and host country supervisors: conflicts which could end up with the adoption, by host country supervisors, of the additional measures provided for in Article 22, whereby fragmenting even more the European supervision of CRAs, increasing substantially the compliance costs and contradicting the very idea of 'a one stop shop'. In addition to that,

reliance on the home country control makes things even more difficult when it comes to CRAs belonging to a group (see Article 14, paragraph 3). The proposal envisages here the appointment of 'a facilitator' to coordinate the supervisory functions of all competent authorities. But this supervisory scheme, albeit implicitly evoking the consolidating supervisor provided for by the CRD Directive, is far from being aligned with the CRD provisions on colleges of supervisors. It should be recalled that under the existing CRD provisions – and even more so under the CRD reform as proposed by the Commission (unfortunately, however, these innovative provisions are on the verge of being removed even from that proposal due to a political compromise fostered by the Council) – the consolidating supervisor has binding decision-making (albeit, currently, on very limited issues) when a unanimous decision cannot be reached. Such a binding decision-making power is not conferred to the facilitator in the CRAs draft regulation. To my mind, therefore, CESR should be given a proper centralized supervisory role in this field. This would allow the testing of the centralized supervisory model before extending it to the entire European financial industry. This is not to say, however, that CRAs' supervision should be entirely transferred to the centre. Quite the contrary. CESR should exert most of its authority through delegation of tasks to the national authorities, retaining at the centre core supervisory decisions (including the adoption of a uniform rule book) whilst desk analysis and on-site inspections should be delegated at the national level, to both the home country supervisor as regards headquarters' supervision and the host countries' supervisors as regards subsidiaries and branches. The current 3L3 reform proposal should in turn facilitate the functioning of CESR as a central authority in this specific domain, probably even without a Treaty amendment. As Governor Mario Draghi recently noted at his Bundesbank lecture 2008 'history has repeatedly shown that needed reforms are ignored until a crisis forces action and that the will to reform quickly dissipates after the crisis has passed. This crisis is no different, and this is an opportunity to strengthen the structure of the financial services industry'. This is particularly true, in my view, to start putting in place a European centralized supervisory architecture.

4. SOME (PROVOCATIVE) CALLS FOR REGULATION ON CRAS' LIABILITY

Finally, I believe that the proposal should be made clearer on the point whether or not ratings are a public good where a general interest is at stake. In my view, they are. In fact, we could live without ratings and especially rating with a recognized regulatory role: investors would be called to assess on their own the risk of the investment, without being influenced by third parties

¹ Bini Smaghi, 'A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market', paper presented at the CPM-IMF Conference in Frankfurt am Main, 26 Sep. 2008, 2.

(specialized) opinions. But if we accept the delegation of this assessment to specialized agencies on the correct assumption that they can more efficiently perform this role, then their ratings should be reliable and considered as given (also) in the public interest. This is not to say that their predictions should prove 100% true or that qualified investors could rely 'blindly' on them. In my opinion it means however that: (a) retail investors should be entitled to sue rating agencies for negligence on a *per se* presumption that they were reasonable to rely on the ratings and the burden of proof that there was no negligence from the side of the CRA should be shifted to CRAs; and (b) qualified investors could also rely on such ratings if they show that they also 'double checked' such ratings through their own analysis on publicly available information and examined the rating methodologies disclosed by the CRA. This is to say that, in my view, the draft regulation should be made more explicit in providing a legal basis for liability actions against CRAs. For sure, *ex post* litigation plays – and shall play – a secondary role in the CRAs' regulation (also considered that CRAs' pockets would easily prove insufficient to face the damages resulting to investors from large failures and that, according to some views, the difference existing between remuneration for the services rendered and risks related thereto might suggest to reasonably cap the liability); but the new regulation should explicitly overrule the well settled US principle whereby, when it comes to CRAs' liability, 'the only common element to these cases is that the rating agencies win'. It should also be remembered that in an often cited precedent of 1999 (*Quinn v. McGraw Hill*), the Court of Illinois (Judge Richard Posner sitting in bench) found that 'while it is unfortunate that Quinn lost its money, and we take him at his word that he would not have bought the bonds without the S&P "A" rating, any reliance he may have placed on that rating to reassure himself about the underlying soundness of the bonds was not reasonable'. Recital 35 of the draft regulation is thus right in saying that 'the stricter and clearer legal framework within which CRAs will operate should also facilitate recourse to civil actions in respect to CRAs in appropriate cases, in accordance with the applicable regimes of liability in the Member States', but this statement should be complemented with a detailed article devoted to civil liability, providing also that investors can sue the CRAs in their own jurisdiction. And, in my view, as regards the standard of care, the regulation should also be clearer (for instance in Article 7, paragraph 2, at the end) in requiring that CRAs perform appropriate due diligence (and not simple 'sniff tests' on the reliability of the information provided to them). As pointed out by the Financial Stability Forum, in structured finance 'due diligence about the quality of operations of originators, issuers or servicers could have identified problems and is important to the assessment of creditworthiness'. Professor Coffee put it even more vividly: 'only those who believe in Santa Claus can fail to recognize that the information provided by loan originators is likely to be biased'.

5. A CONCLUSION WITH SOME, EVEN MORE PROVOCATIVE, CALLS FOR REGULATION ON CRAS' APPOINTMENT. THE QUESTION ON HOW TO STOP RATING SHOPPING, ENSURING INDEPENDENCE AND OPENING UP OF A TOO OLIGOPOLISTIC MARKET

Finally an issue not covered by the proposal: the appointment of the CRA. In the issuers-paid model, CRAs are paid and appointed by the issuer. This prompted a practice of 'rating shopping', especially by arrangers of structured finance instruments: the rating was commissioned to the most benign (i.e. lenient) agency. In an oligopolistic market strongly influenced by the demand organized by investment banks this competition in laxity proved to be very dangerous. It contradicts moreover the 'gatekeeper', or at least the statutory role given to CRAs, centred on their independent professional assessment. This is why I ask myself – being well aware of how provocative this question may appear – whether it is not time to confer to the supervisory authority also the power to appoint, upon request of the issuer, the CRA called to deliver the rating. Albeit CESR expressed its concerns due to possible involvements in liability actions for '*culpa in eligendo*', this risk seems to me quite marginal, whereas I feel that a public intervention at the appointment stage could prove very useful to address both the problems of CRAs' independence and of the opening up of the still oligopolistic structure of the market. On the one hand, it would increase the accountability of the CRA to the supervisors and, on the other hand, it would favour a more transparent, open and competitive allocation of market opportunities.