

Chirico, Alessandra

Working Paper

Credit Rating Agencies: The Main Lacuna in EU Regulation Governing Conflicts of Interest

ECMI Commentary, No. 17

Suggested Citation: Chirico, Alessandra (2008) : Credit Rating Agencies: The Main Lacuna in EU Regulation Governing Conflicts of Interest, ECMI Commentary, No. 17, CEPS, Centre for European Policy Studies, Brussels, Belgium

This Version is available at:

<https://hdl.handle.net/10419/109213>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Credit Rating Agencies: The Main Lacuna in EU Regulation Governing Conflicts of Interest

ECMI Commentary No. 17
31 January 2008

Alessandra Chirico*

Credit Rating Agencies (CRAs) play a key role in European capital markets today, publishing opinions ('ratings') on the creditworthiness of issuers/issues of debt securities. Independent, objective and internationally consistent credit ratings raise the integrity, transparency and competitiveness of capital markets, lower the costs of capital for issuers and contribute to investor protection. Moreover, ratings are widely used by investors as a guide to the creditworthiness of the issuers of debt, and in financial covenants. As a result, CRAs play a major role not only in the pricing of debt securities, but also in the regulatory process.¹ It may well happen, in fact, that regulators co-opt rating agencies as information-producing agents for regulatory purposes. In this way, when ratings serve not just as a tool for investors but become the very foundation for regulation, they become extremely powerful, and as a consequence, the risk that conflicts of interest will arise becomes much sharper.

In recent years, however, CRAs have attracted the attention of policy-makers at national, European and international levels – given the important role their opinions play in capital markets and the questions raised over their response to corporate scandals in the US and Europe, as well as over certain ratings decisions in Europe. In parallel, a greater regulatory reliance on ratings was introduced in the Basel II capital accord, and the EU's Capital Requirements Directive (CRD).

In these situations, conflicts of interest can arise from the fact that there are multiple users of ratings whose interests can diverge, at least in the short term. On the one hand, investors and regulators are interested in well-researched, impartial assessments of credit quality whereas issuers, on the other hand, primarily want favourable ratings.

¹ It is worth recalling that regulators also use credit ratings, or permit these ratings to be used for regulatory purposes. This is the case under the Basel II agreement of the Basel Committee on Banking Supervision and the Capital Requirements Directive (CRD). For the purpose of calculating their minimum capital requirements, the Basel II rules allow banks to assess their counterparty credit risk by using external ratings. Only ratings provided by approved institutions, called the External Credit Assessment Institutions (ECAIs), are allowed. Leaving aside possible issues that arise from approval and entrenchment, Basel II offers the agencies new opportunities and new roles as a key player in the determination of global financial stability.

Alessandra Chirico, Ph.D. is Head of Research at the European Capital Markets Institute (ECMI) and a Research Fellow at the Centre for European Policy Studies (CEPS) in Brussels. She can be reached by phone at +32 2 229 39 58 or by email (alessandra.chirico@ceps.eu). Valuable comments from Karel Lannoo and Rym Ayadi are gratefully acknowledged.

ECMI Commentaries provide short comments on ongoing developments affecting capital markets in Europe. ECMI researchers as well as external experts contribute to the series. The views expressed are attributable only to the author in a personal capacity and not to any institution with which she is associated.

Because the latter pay to have their securities rated, there is a fear that credit agencies may bias their ratings upwards in order to attract more business.

Although, in principle, a CRA's duty is to consistently provide ratings that are independent, objective and of the highest possible quality, the August 2007 financial market turmoil gave evidence of malpractice. In the recent subprime lending crisis, credit rating agencies have come under increasing fire for their supposed collusion in favourably rating junk Collateralised Debt Obligations (CDOs) in the sub-prime mortgage business. As a result, credit rating agencies have been called to a special meeting by the world's securities regulators – the International Organization of Securities Commissions (IOSCO) – to explain how they rate structured financial products based on mortgage assets. This move shows that serious concern over the potential for conflicts of interest between the agencies and the issuers whose securities they rate has risen to the top of the agenda for regulators.² At a hearing before the US Senate Banking Committee in September 2007, for instance, the Chairman of the Securities and Exchange Commission (SEC), Christopher Cox, said the Commission was examining whether the credit agencies had “compromised their impartiality” when they simultaneously rated various mortgage-backed securities and provided advice to Wall Street investment firms about how to package them so as to gain higher credit ratings. The SEC has therefore opened a formal investigation into whether the credit-rating agencies improperly inflated their ratings of mortgage-backed securities because of possible conflicts of interest.

Regulating CRAs in Europe: Should the Commission re-evaluate its light-touch approach?

Already at the aftermath of the Enron collapse, the reliability of CRAs was discussed at the Oviedo ECOFIN meeting in April 2002, and at the European Securities Committee meetings in May and September 2003. In February 2004, even before the failure of all major CRAs to anticipate the Parmalat default, the European Parliament passed a resolution calling on the European Commission to submit by 31 July 2005, its assessment of whether and how CRAs should be regulated, and in particular, of the need for legislative measures. The Commission called on the Committee of European Securities Regulators (CESR) for advice on this matter. In response, CESR released a consultation paper in November 2004 and issued its final advice to the Commission on 30 March 2005. Despite the European Parliament's initial preference for pervasive regulation, the Technical Advice recommended a non-legislative solution, based on CRA self-regulation through the adoption of individual codes of conduct formulated along the lines of the IOSCO code.

Later on, in January 2006, the European Commission argued that existing financial services directives applicable to CRAs (Market Abuse, Capital Requirements Directive and MiFID) – combined with a comply-or-explain approach by the CRAs on the basis of the IOSCO code – provided the way forward in this area. Hence, through these policy

² Recent criticism has in particular addressed the overly positive opinions issued by agencies on the creditworthiness of mortgage-related securities (based on underlying assets now in severe distress due to the subprime meltdown), pointing to the fact they are often paid for by the issuers of such securities. Ratings are usually requested – and paid for – by the issuers themselves. In these cases, they are based on both publicly available data and information that are not accessible to the public but which are voluntarily disclosed by the rated entity (e.g. by means of interviews with senior financial officials of the rated entity).

initiatives, CRAs have been incorporated into the financial market regulatory landscape.³

It has to be emphasised, however, that MiFID and its implementing measures are not *tout court* applicable to the rating process of credit rating agencies, whenever the rating process itself does not involve the firm undertaking investment services and activities or providing investment advice as defined in the Directive. In other words, the issuing of a credit rating will *normally* not result in the credit rating agency also providing ‘investment advice’ within the meaning of Annex I to the MiFID. Nevertheless, credit rating agencies should be aware of the precise limits of the rating activity they carry out in order to continue to operate outside MiFID regulation.

For the purposes of the definition under MiFID, in fact, ‘investment advice’ is a personal recommendation made to a person in his capacity as an investor or potential investor, presented as suitable for that person. This means that the recommendation must be based on a consideration of the specific circumstances of that person, and must constitute a recommendation to take one of the following sets of steps:

- a) to buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular financial instrument; or
- b) to exercise or not to exercise any right conferred by a particular financial instrument to buy, sell, subscribe for, exchange or redeem a financial instrument.⁴

As a result, whenever a CRA negotiates together with the issuer how to structure a product in order for the issuer to get better ratings, it provides the issuer with personal recommendations relating to a specific financial instrument, constituting investment advice. In particular, if credit rating agencies also provide these services on a professional basis, they should require authorisation under MiFID. Only in such cases where they provide investment advice, the MiFID provisions regarding conduct of business and organisational requirements (including management of conflicts of interest) will apply to the firm and its undertaking of investment services and activities.⁵

Yet, in light of the recent market turmoil, one may wonder if this is enough? As already outlined, CRAs provide ratings to investors on structured finance, while, at the same time, they provide advice to banks on how they should structure their lending to get the best ratings. The allegation – made clear by many commentators – is that analysts *may give* unduly favourable ratings to induce issuers to pay additional fees for other services,⁶ not that they give unduly unfavourable ratings to persuade issuers to pay for

³ European Commission (2006), *Communication from the Commission on Credit Rating Agencies*, (2006/C 59/02).

⁴ See Art. 52, Commission Directive 2006/73/EC of 10 August 2006.

⁵ Where, for example, a credit rating agency provides investment services (such as investment advice) to clients that fall under the MiFID, the provisions on conflicts of interest will apply to protect the interest of those who receive these services. The provisions on conflicts of interest may require an appropriate degree of separation of investment services from the credit rating process, so that ancillary services may not interfere with the quality and objectivity of credit ratings.

⁶ Although the provision of ratings is their core activity, many credit rating agencies make use of their expertise in risk assessment to provide other financial services (e.g. investment advice) to issuers (either directly or through related entities). Credit rating agencies are also increasingly involved in the assessment of the risks associated with assets held by financial institutions which are subject to capital adequacy requirements. In the case of the provision of ancillary consulting services, the credit rating agency would be in the position of “auditing its own work,” raising conflicts of interest similar to those in accounting firms when they provide both auditing and consulting services. Furthermore, providing consulting services creates additional incentives for the rating agencies to deliver more favorable ratings

the ratings. According to Frank Partnoy, Professor of Law at the University of San Diego Law School, “the securities analyst conflicts are ‘pull’ conflicts in which the analyst dangles the prospect of favourable ratings to obtain future fees, whereas the rating agency conflicts are ‘push’ conflicts in which the agency threatens the issuer with unfavourable ratings to obtain current fees”.⁷ This situation is even more difficult to assess, also because there is a general lack of transparency in the fee structure charged by CRAs.

Concerns centre on the quality of credit ratings provided by credit rating agencies. Credit rating agencies must base their ratings on a diligent analysis of the available information and control continuously for the integrity of their information sources. This means that credit ratings must be regularly updated, if necessary. Credit rating agencies must also be more transparent about the way in which they arrive at their ratings. In addition, it is important that credit rating agencies are independent and entirely objective in their approach. In particular, the position of credit rating agencies must not be compromised by the relationships they have with issuers or by the access they have to inside information of issuers. It is important that credit rating agencies are prevented from using this information for other activities.

Reassuringly, in a recent note provided by the Economic and Financial Committee on the current financial markets situation, a call for “a better insight into the incentive structures, including possible conflicts of interest and disincentives to perform proper due diligence, faced by credit originators, credit rating agencies and other market participants” was put forward.⁸ The EU will thus give high priority to scrutinising the role of credit rating agencies, with a particular focus on structured finance instruments, conflicts of interest and transparency of rating methods.⁹ These items also currently feature on the agenda of the EU-US Financial Markets Regulatory Dialogue at the level both of Commission-US authorities and CESR-SEC.

Finally, what should be borne in mind is that the self-regulatory approach is not sufficient. Principles and codes of conduct must be implemented in practice on a day-to-day basis. CESR has been given the major task to monitor compliance with the IOSCO code and to report back to the Commission on an annual basis. The ratings industry should thus be aware that the Commission may have to take legislative action, if it becomes clear that compliance with EU rules or the code is unsatisfactory and damaging EU capital markets. That time may have already come.

in order to further their consulting business.

⁷ Frank Partnoy, “How and Why Credit Rating Agencies Are Not like Other Gatekeepers”, paper presented at the Brookings-Nomura Seminar, Washington, D.C., 28 September 2005 (downloadable at http://www.tcf.or.jp/data/20050928_Frank_Partnoy.pdf).

⁸ See *Key issues and follow-up actions*, released by the Council of the European Union, 5 October 2007, DS 787/07.

⁹ At the moment, work is being pursued and first conclusions should be released in spring 2008.