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COMMENTS ON THE ROUNDTABLE ON OVERSIGHT OF CREDIT RATING AGENCIES

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Summary

"What went wrong?"

- Current issues related to rating agencies - conflicts of interest, transparency and market perceptions, competition… - are broadly similar to those raised in 2002, as the main concerns related to the rating system have not been addressed/resolved by regulatory authorities during previous regulatory processes (Part I, see pages 3-6).
- Specific issues related to structured finance products were already identified by some regulatory authorities. In particular, the Bank for International Settlements published a report in 2005 in which the possible issues arising for structured finance products were stressed, *i.e.* model risk and conflicts of interest (Part II, see pages 7-8).

"Competition issues: what are current barriers to entering the credit rating industry?"

- Regulation can have adverse effects on the rating industry and market participants. Indeed, they can create barriers to entry because of regulation and the recognition of rating agencies (Part III, see pages 9-10).

"What corrective steps is the industry [not] taking?"

- Regulatory authorities have taken some corrective steps. Even though some rules proposed by the U.S. Securities and Exchange Commission[2] are welcome - to the extent that it may increase the "integrity" of the rating industry -, others do not seem adequate (Part IV, see pages 11-12).
- Furthermore, some key points, linked to competition and independence of rating agencies, do not seem to have been sufficiently addressed. Indeed, the recognition of 11 NRSROs does not seem sufficient to ensure competition. Furthermore, as far as I know, preliminary ratings, ancillary services, circularities… do not seem to have been fully considered (Part V, see pages 12-14).

"Approaches to improve credit rating agency oversight"

- In order to approach this problematic, one may wonder if regulatory authorities and the Commission, in particular, are credible to oversee the rating industry (Part VI, see pages 15-20).

[2] Or Commission or SEC in this paper.

"What went wrong?"

Part I - Current regulatory issues are broadly the same than the ones raised in 2002

In 2002, the regulatory process of the rating industry was reinitiated[3] in the United States, after some corporate failures (Enron and Worldcom collapses illustrate this period), with the analysis of the role of rating agencies in financial markets. Two actions took place: because issuers and investors called for more transparency from rating agencies[*e.g.* the AFP survey (2002)], some of them like Moody's and Standard & Poor's carried out surveys [*e.g.* Moody's (2002a, 2002b) and Standard & Poor's (2002)]; regulatory authorities had/wanted to regulate rating agencies because of political pressures/mandates and public concerns. Transparency, market perception, reliability, independence, conflicts of interest, competition were the main themes analysed in 2002. The criticisms levelled at the rating industry mainly concerned the "Main Three"[4].

This regulatory process led, in the United States, to the Credit Rating Agency Reform Act (2006) in order to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the rating industry"[5] and, latter, to the Final Rules of the U.S. Securities and Exchange Commission (2007). Other regulatory authorities took steps in Europe or at worldwide level (*e.g.* the IOSCO Code of Conduct).

Unfortunately, despite of numerous reports, codes of conduct, new rules…, the issues raised during the current financial crisis are broadly the same![6] A brief analysis of the "possible regulatory issues" pointed out by the recent regulatory authorities' consultation supports this conclusion[7].

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[3] The SEC tried to improve its oversight on rating agencies, through its NRSRO qualification in 1994 and 1997.

[4] For instance, the hearings conducted by the US authorities in 2002 mainly dealt with Standard & Poor's, Moody's and Fitch. See the hearings conducted by the U.S. Senate in 2002: United States Senate, 2002a, "Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Committee on Governmental Affairs United States Senate", Committee on Governmental Affairs, March 2002, One Hundred Seventh Congress, Second Session; United States Senate, 2002b, "Financial Oversight of Enron: the SEC and Private-Sector Watchdogs", Report of the Staff of the Senate Committee on Governmental Affairs, S.Prt. 107-75, October.

[5] *In* U.S. Securities and Exchange Commission, 2008a, "Proposed Rules for Nationally Recognized Statistical Rating Organizations", 17 CFR Parts 240 and 249b, Release n°34-57967; File n°S7-13-08.

[6] Except specific issues linked to the particularities of structured finance.

[7] See for example the consultations of CESR, IOSCO, and the SEC in 2007 and 2008.

1-Issues of 2002 are the same in 2008

It is possible to refer to the 2008 IOSCO consultation[8] to demonstrate this point. Related to its Code of Conduct, it considered the following subjects:

- **CRA transparency and market perceptions**. The facts that CRA "do not publish verifiable and easily comparable performance data regarding their ratings"[9], that "statistics regarding long term default rates do not necessarily provide information about short term default probabilities"[10], that CRA were to "slow to review, and if necessary, downgrade existing credit rating" and by contrast "that some CRA very quickly downgraded certain structured finance product"[11] were pointed out in 2002. The sole criticism that could be considered as new is that CRA "have been slow to modify either their methodologies or the assumptions used by their methodologies".

- **Independence/avoidance of conflicts of interest**. Once again, the "issuer fee model" used by the main rating agencies is criticised. Actually, it is a concern since they have adopted this business model during the 70's. For which reasons independence is still a concern whereas, broadly, market participants recognised that rating agencies managed this conflict of interest?

- **Competition**. Once again, the question of competition is raised[12]. Regulatory authorities are mindful of the reasons explaining the lack of competition - "as the CRA report notes, some observers believe the nature of the CRA "market" may make it difficult for new CRA entrants to succeed"[13] -. But are they aware of their own role and of the potential negative effects they can produce on the rating industry?

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[8] IOSCO, 2008, "The role of credit rating agencies in structured finance markets", Technical Committee of the International Organization of Securities Commission, March.

[9] As in 2003 when the U.S. Securities and Exchange Commission called for comment on the standardization of rating symbols for example. For further details, see U.S. Securities and Exchange Commission, 2003a, "Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", Release n°33-8236, 34-47972; File n°S7-12-03, June.

[10] As in 2000-2002 when corporate default rates were higher than its long term average. For more details, see for example Raingeard O., 2003, "Comments of Olivier Raingeard on S7-12-30", Securities and Exchange Commission Concept Release: "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 27.

[11] As in 2002 when issuers believed that "rating upgrades take longer to occur compared to rating downgrades". According to the AFP survey (2002), "most respondents do not believe changes in their company's finances are promptly reflected in the ratings" *in* Association for Financial Professionals, 2002, "Rating Agencies Survey: Accuracy, Timeliness, and Regulation", November.

[12] Market participants called for more competition in the rating industry, as it is shown - for instance - by the AFP Survey (2002) which stated that "[T]reasury and finance professionals support additional competition in the market for credit ratings".

[13] *In* IOSCO (2008), see footnote 8.

Consequently, despite few progresses made by rating agencies since 2002, "partly" due to regulation, one should consider that issues related to the rating industry have not been resolved. The issues concerning conflicts of interest are a good illustration.

2 - Focus on the issues of conflicts of interest

At first sight, it is logical to consider the fact that a rating agency paid by the issuer, which wants to "obtain the best grade", constitutes a conflict of interest. Nonetheless, it seemed broadly admitted by market participants that credit rating agencies, *i.e.* the "Main Three", managed this conflict of interest because credibility is probably one of the most important criterion of this industry. Besides, Covitz and Harrison (2003) found evidences that reputation incentives dominate for Standard & Poor's and Moody's: "[R]ating agencies appear to be relatively responsive to reputation concerns and so protect the interests of investors"[14] and the Commission (2003) stated that "the practice of issuers paying for their own ratings creates the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information (…) The larger rating agencies and a number of other market participants agree that the issuer-fee model creates the potential for a conflict of interest, but believe that the rating agencies historically have demonstrated an ability to effectively manage the potential conflict"[15].

For which reasons this potential conflict of interest is still a concern despite of this general acceptance? Several reasons can be advanced:

- as noticed by the Commission, the "issuer/underwriter pay" conflict is more acute in structured finance "because certain arrangers of structured finance products repeatedly brings rating business to the NRSRO"[16]. Besides, the Staff of the Office of Compliance Inspections and Examinations (2008) underlines this weakness: "the combination of the arrangers' influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appear to have heightened the inherent conflicts of interest that exist in the "issuer pays" compensation model."[17] Furthermore, as stressed by the CESR (2008a), the nature of structured finance "means that issuers can

[14] *In* Covitz D., Harrison P, 2003, "Testing Conflicts of interest of Bond Rating agencies with market anticipation : Evidence that reputation Incentives Dominate", Finance and Economics Discussion Series 2003-68, Board of Governors of the Federal Reserve System.
[15] *In* U.S. Securities and Exchange Commission (2003a), see footnote 9.
[16] *In* U.S. Securities and Exchange Commission (2008a), see footnote 5.
[17] *In* U.S. Securities and Exchange Commission, 2008b, "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies", by the Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis, July.

bring repeat business to the CRAs. This might drive them to favour business volume instead of rigorousness and independence and hence to 'overrate' transactions in order to maintain a profitable flow of business from arrangers"[18].

- One should also consider that few rating agencies practices and the development of ancillary services create/exacerbate this potential conflict of interest and contribute to have doubts about the independence of rating agencies. For instance, the fact that rating agencies do not charge fees when issuing a preliminary rating reinforces this "issuer/underwriter influence" on two levels[19]:
    - rating agencies "increase" their dependence to the issuer/underwriter/arranger as they can be "forced" to respond to the willingness of the latter in order to be paid and conserve/gain market share;
    - it reinforces rating shopping practices as the issuer/underwriter/arranger can look for the best rating.

  This issue related to preliminary rating is not new! This kind of problems has already been raised. Raingeard (2003, 2004, 2005a) pointed out that preliminary corporate ratings[20] used by certain rating agencies increase this potential conflict of interest and submitted the idea to prohibit this practice.

  Concerning the development of ancillary services, the lack of thinking on ancillary services has probably contributed to create/exacerbate the potential conflict of interest. Indeed, as far as I know, regulatory authorities do not identify the different advisory/ancillary services proposed by rating agencies and their affiliates; IOSCO (2008) only proposes to "force" credit rating agencies to disclose "what it considers, and does not consider, to be an ancillary business and why"[21]; the CESR (2008b) claims that it "has, so far, been unable to completely satisfy itself over the segregation of rating and ancillary services business at the CRAs due to the lack of a clear definition of what an ancillary business is (…)"[22].

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18 *In* Committee of European Securities Regulators, 2008a, "The Role of Credit rating Agencies in Structured Finance", Consultation paper, February.

19 "Typically, the rating agency is paid only if the credit rating is issued, though sometimes it receives a breakup fee for the analytic work undertaken even if the credit rating is not issued." *In* U.S. Securities and Exchange Commission (2008b), see footnote 17.

20 After the initial contact between the agency and the issuer and the communication of the appropriate information, few rating agencies (NRSROs and non-NRSROs) provide a preliminary rating, which can be comprised within a range (*e.g.* a preliminary rating A+/A; in certain cases, a probability of realisation is indicated). If the issuer accepts this preliminary rating, the rating procedure is engaged; otherwise, he can drop the process.

21 *In* IOSCO (2008), see footnote 8.

22 *In* Committee of European Securities Regulators, 2008b, "CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance", May.

Part II-Specific issues raised by structured finance product were already identified in 2005

Most of the reports consider rating agencies as a key actor of the current market turmoil[23]. Nonetheless, in 2005, the Committee on the Global Financial System stated that "[I]nvestors do not appear to be overly reliant on ratings in making structured finance investment decision. In fact, Working Group's interviews with investors and other market participants suggest that, in general, investors are aware of the risk of basing their investment decisions solely on ratings. In other words, investors view ratings as just one part of an informed investment decision."[24]

Looking at the usefulness of rating, the Committee on the Global Financial System (2005) stated that "deal origination implicitly involves obtaining structure advice by the rating agencies" and that "it is generally more difficult for investors to obtain information about the performance of structured finance pools"[25]. More interestingly, the report emphasized possible issues arising for structured finance markets linked to model risk and rating agency conflicts of interest. The Committee warned that "model-based risk assessments can be a long way from "true" values and, to the extent that investors rely on ratings for their structured finance investments, the model risk linked to the agencies' rating methodologies will be among the principal risks these investors are exposed to."[26]
Concerning conflicts of interest, even though the Committee claimed that "the fact that the agencies may have expressed an "ex ante opinion" regarding deal structure suggests that they are providing structuring advice"[27], it believed "that the complexity of managing potential conflicts of interest has not been altered by the agencies' involvement in rating structured finance instruments"[28]. Nevertheless, it stressed that "the potential for advisory fee-related conflicts of interest would arise in the future and could meaningfully affect the complexity of managing these conflicts going forward."[29]

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[23] See for example the report of the President's Working Group on Financial Markets (2008): "the principal underlying causes of the turmoil in financial markets were (…) a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies (…) flaws in credit rating agencies' assessments…"
[24] *In* Bank for International Settlement, 2005, "The role of ratings in structured finance: issues and implications", Committee on the Global Financial System, January.
[25] *In* Bank for International Settlement (2005), see footnote 24.
[26] *In* Bank for International Settlement (2005), see footnote 24.
[27] *In* Bank for International Settlement (2005), see footnote 24.
[28] *In* Bank for International Settlement (2005), see footnote 24.
[29] *In* Bank for International Settlement (2005), see footnote 24.

The Committee concluded that "unexpected losses on structured finance investments could thus become an issue going forward, particularly once the current environment of low default rates and tight credit spreads comes to an end (…) The occurrence of worst case scenarios on the basis of mispriced or mismanaged exposures might thus lead to situations in which extreme market events could have unanticipated systemic consequences."[30] Consequently, it seems that regulatory authorities were mindful of the potential risks. Nonetheless, as far as I know, the report had not consequences on the rating industry.

Does it makes sense to identify the potential conflicts of interest and the limits of credit rating in structured finance and to deal with them, three years latter, once problems and limits arise?

[30] *In* Bank for International Settlement (2005), see footnote 24.

“Competition issues: what are current barriers to entering the industry?”

Part III-The specific question of competition

Looking at the consultation of IOSCO (2008) or at this current roundtable, it appears that the question of competition is, again, raised. Even though regulatory authorities are mindful of the difficulties in increasing competition, there is still the will, particularly of the U.S. Securities and Exchange Commission, to “foster competition”[31]. IOSCO (2008) noticed that “CRA Report noted in 2003 that CRAs were not extensively regulated in most IOSCO jurisdictions and those regulations that did exist are not onerous for new entrants”. One may wonder if regulatory authorities are aware of their own role and of the potential negative effects that they can produce on the rating industry. Indeed, has not the U.S. Securities and Exchange Commission regulated the rating market - the main market for the rating industry - with its NRSRO qualification since 1975?

In order to address the question of competition in the rating industry, theoretical conditions - homogeneity, transparency and free access to the market - have to be analysed.
Is there any homogeneity on the rating market? The rating is not necessarily “a homogeneous product”. Numerous researches demonstrate that differences of reliability and credibility exist between rating agencies.[32]

Is there any transparency on the rating market? If the “fee models” are disclosed, rating’s prices are not necessarily transparent, *e.g.* the NRSROs, as far as I know, do not publicly disclose them. Besides, the U.S. Securities and Exchange Commission (2007) believes that its final rule on the oversight of credit rating agencies registered as Nationally Recognized Statistical Rating Organizations “should elicit more information about fees so that the information will be disclosed to users of credit ratings. This will improve price transparency, which may lead to greater competition.”[33]

[31] *In* U.S. Securities and Exchange Commission (2008a), see footnote 5.
[32] For further details, see Raingeard (2005b) demonstrating that differences of reliability between rating agencies exist. It also appears that differences of rating agencies’ credibility can be observed [*e.g.* Cantor, Packer and Cole (1997), Raingeard (2005b) find that Standard & Poor’s and Moody’s have the same credibility; contrary to Jewell and Livingston (1999), it seems that Fitch has a specific credibility (Raingeard, 2005b)].
[33] *In* U.S. Securities and Exchange Commission, 2007, “Final Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations”, Release n°34-55857; File n°S7-04-07, June 5.

Is the market free to access? Natural barriers to entry linked to credibility, reliability and time and resources necessary to set them up exist. Nevertheless, one could consider that there are exogenous barriers related to the role of regulatory authorities.

The lack of transparency/accuracy of the NRSRO status has probably dissuaded potential competitors. Indeed, the SEC did not disclose applications for NRSRO recognition and did not define a planning for its decision. For example, Lace Financial Corporation (2002) criticised the NRSRO status: "I would hope that this time the SEC would process our appeal for NRSRO status on a more timely process (the last application took eight years). It would also be helpful if the Division of Market Regulation could be more forthright with us and tell us in writing what part of the SEC criteria we do not meet."[34] Moreover, even though the U.S. Securities and Exchange Commission (1997) stated that "the single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings"[35], several criteria of its recognition were not necessarily objective or accurate[36].

The conditions for competition were not "secured". The fact that Moody's and Standard & Poor's rate, in the United States, all public corporate debt issues has probably hindered the development of competitors. As an example, Standard & Poor's admits that it rates "99,2% of the debt obligations and preferred stock issues publicly traded in the United States"[37]. Therefore, in the United States, corporate issuers have *de facto* two ratings, with or without request, contributing to hinder rating agencies' development. This has probably led Fitch to develop its activities by acquisitions of some NRSROs[38]. As a result, the U.S. Securities and Exchange Commission - despite some recognition - has not necessarily secured the conditions for competition as it does not regulate this systematic rating policy.

The use of ratings for regulatory purpose has probably contributed to this result too. Indeed, regulatory authorities, by recognising/qualifying rating agencies and using their ratings for regulatory purposes, encourage issuers to request a "recognised/qualified rating" because of credibility recognition, notoriety effect, and regulatory concerns[39]. This influence is well-known: "to the extent that regulatory recognition is based on reliance by market, and market reliance is influenced by regulatory recognition, the cycle of discrimination is perpetual."[40]

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34 *In* Lace Financial Corporation's Letter to the SEC, 2002, "Appeal for Lace Financial Corporation to receive Nationally Recognized Statistical Rating Organization status", September 26. Nonetheless, the Commission has addressed this weakness since 2007.

35 *In* U.S. Securities and Exchange Commission, 1997, "Capital Requirements for Brokers or Dealers Under the Securities and Exchange Act of 1934", "Proposed Rule", Release n°34-39457; File n°S7-33-97, December 17.

36 See, for example, Rating and Investment Information's comments on the SEC's Concept Release (2003) or Raingeard (2003).

37 *In* Standard & Poor's, 2003, "Corporate Rating Criteria".

38 Fitch Ratings is the result of several merger/acquisition with other NRSROs.

39 U.S. authorities use ratings in their regulations in order to "secure their financial system". For further details, see for example Cantor and Packer (1995) and the U.S. Securities and Exchange Commission (1997).

40 *In* IOSCO (2008), see footnote 8.

“What corrective steps is the industry [not] taking?”

Part IV-What corrective steps is the industry taking?[41]

The regulatory authorities have taken corrective steps since 2002. Nevertheless, some rules or principles have not been respected and some rules have not been sufficient to address the key issues related to the rating activity.

1-Code of conducts and elementary principles not respected

Several corrective steps have been taken by regulatory authorities for many years. Unfortunately, they were not necessarily respected.

For instance, it is well-known by market participants and regulatory authorities that, in order to reduce the potential issuer’s influence and increase transparency, rating agencies should ensure the independence of people involved in the rating process through policies and procedures. However, the Staff of the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission (2008) notices that “while each rating agency has policies and procedures restricting analysts from participating in fee discussions with issuers, these policies still allowed key participants in the rating process to participate in fee discussion.”[42]

It is also well-known by market participants and regulatory authorities that the criteria of exhaustive rating definition and key rating’s process may contribute to the credibility of the industry. Nonetheless, concerning structured finance, the Staff of the U.S. Securities and Exchange Commission (2008) reveals that “relevant ratings criteria were not disclosed. Documents reviewed by the Staff indicate the use of unpublished ratings criteria.”[43]

More broadly, the CESR (2008b) notices that “there are still some areas where the CRAs do not comply with the IOSCO Code (…) This non-compliance, even though there are explanations, indicates that some of the issues which the IOSCO Code is intended to address, are not being managed through the CRAs Codes in a manner that matches the IOSCO Code provisions exactly…”[44]

One should expect that current rules, aimed at reducing potential issuer’s influence and at increasing transparency and credibility, will be respected.

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[41] I do not consider the corrective steps taken by market participants as this comment mainly focuses on the regulatory actions.
[42] *In* U.S. Securities and Exchange Commission (2008b), see footnote 17.
[43] In U.S. Securities and Exchange Commission (2008b), see footnote 17.
[44] *In* Committee of European Securities Regulators (2008b), see footnote 22.

2-Inappropriate rules taken by regulatory authorities to address key issues

Some rules have been adopted but are probably inappropriate to reach their objective. For instance, the prohibition to "an NRSRO from having a conflict relating to the issuance of a credit rating where the person soliciting the credit rating was the source of 10% or more of the total net revenue of the NRSRO during the most recently ended fiscal year"[45] or the obligation to "publicly disclose the names of the rated entities or related third parties from which it receives more than 5% of its annual revenue"[46] will not modify significantly the situation as it is probably already implemented in practice. It will mainly concern smaller rating agencies that have a more concentrated turnover's structure. Finally, it can create a barrier to entry. Besides, the Commission has "provided two small NRSROs with temporary exemptive relief from the prohibition in Rule 17g-5 against receiving 10% or more of their net revenues from a single client"[47]. Furthermore, it would not resolve entirely the concerns related to potential conflicts of interest because the main issues are not addressed.

Propositions to clearly identify the rating of structured products are useless. I think that investors are now mindful of the fact that "there are different rating methodologies and risk characteristics associated with structured finance products"[48]. Furthermore, one should expect that investors look for understanding constantly the types of debt they buy.

Last, as stated earlier, the lack of transparency of the NRSRO recognition process has probably dissuaded potential competitors. The U.S. Securities and Exchange Commission has improved its recognition process in 2007 with the definition of the "rules of game". Nevertheless, nowadays, the multiplication of regulations at a worldwide level raises concerns as it may create new barriers to entry to the market (see further).

Part V-What corrective steps is the industry not taking?

One could consider, by looking at the different proposed rules and final rules of the U.S. Securities and Exchange Commission, that the nature of the regulation has changed. In other words, it seems that the legal approach is more and more applied in order to regulate the rating industry, the economic approach becoming less important.

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[45] *In* U.S. Securities and Exchange Commission (2007), see footnote 33.

[46] *In* Commission of the European Communities, 2008, "Proposal for a regulation of the European Parliament and of the Council on credit rating agencies", 2008/0217 (COD).

[47] *In* U.S. Securities Exchange Commission, 2009, "Amendments to Rules for Nationally Recognized Statistical Rating Organizations", Release n°34-59342; File n°S7-13-08, February 2.

[48] *In* U.S. Securities and Exchange Commission (2008a), see footnote page 5.

1- Is the recognition of 11 NRSROs sufficient to guarantee competition?

The Commission is currently recognizing 11 NRSROs. But is it sufficient to guarantee competition? As stated earlier, from an economic point of view, competition depends on transparency and free access to market.

Is transparency ensured? In order to increase transparency, rating agencies could improve the documentation of their rating scheme, *e.g.* what are the determinants of the rating's price? To what extent rating's prices could be subject to negotiation? Does the credit rating agency use an annual subscription fee that can be used as a credit against future debt issuance? (Etc) **Is this kind of information currently disclosed?**

Is the market free access? As stated earlier, the U.S. Securities and Exchange Commission - despite some recognition - has not necessarily secured the conditions for competition as it does not regulate this systematic rating policy. Nevertheless, has the SEC the power to take action? Standard & Poor's and Moody's policies rely, in the United States, on the First Amendment protection - rating is an opinion - and the so-called "journalist's privilege". Furthermore, it seems that rating agencies have to adopt such systematic rating policy in order to be considered as a journalist. Indeed, in the case In RE Fitch, the Court finds that "unlike a business news paper or magazine, which would cover any transactions deemed newsworthy, Fitch only "covers" its own clients. We believe this practice weighs against treating Fitch like a journalist."[49] Consequently, it seems that, from a legal point of view, there is not the same level playing field between rating agencies. **Has this point been analysed by the Commission?**

2-Are the current rules sufficient to ensure rating agencies independence?

Regulatory authorities should deal with potential conflicts of interest linked to preliminary ratings, ancillary services and reputational risks. Few propositions could contribute to monitor those potential conflicts of interest and to reinforce the image of rating agencies independence.

Preliminary ratings should be prohibited. Perhaps rating agencies could argue that such a rule would affect their rating methodologies and deteriorate their rating process. **Nonetheless, from my point of view, the practice of preliminary rating - which reinforces rating shopping practices - is more a commercial tool rather than a part of the rating methodology.**

[49] *In* United States Court of Appeals for the Second Circuit, 2003, Docket Nos 03-7062, 03-7076, May 21.

Concerning advisory/ancillary services, needless to say that the first task of regulatory authorities will be to identify the different services proposed by rating agencies and their affiliates and not only to charge credit rating agencies to disclose "what it considers, and does not consider, to be an ancillary business and why". Then a set of rules should be defined. For instance, for rating assessment services, a formalised issuer's request should be required; an explicit statement indicating that the rating assessment does not mean that the effective rating will correspond to the estimated one; the "prohibition" of a rating assessment when the rating agency carries out a rating action; possibly, the disclosure of the rating assessment by the rating agency or the issuer to investors[50]. Consulting services through "independent affiliates" (which, for example, deal with management, strategic risks…) should be at least regulated by a non-overlapping benefits rule (despite implementation difficulties) or prohibited[51].

Last, regulatory authorities should consider the consequences of circularities and reputational risk. In 2005, the Committee on the Global Financial System studied the potential conflict of interest arising "when the ratings of some structured credits are contingent on the agency's own rating of a monoline insurer that provides credit enhancement to the most senior tranche(s) of these structures."[52] Rating agencies considered that those "circularities issues in rating monolines were not different from, for example, rating sovereigns"[53]. It implied "that the agencies' problem with regard to managing potential conflicts of interest is not a new one."[54] Is this assumption valid?

The Staff of the Office of Compliance Inspections and Examinations (2008) reveals that "members of the committee, all analysts or analytical managers, considered the rating agency's reputational interest in not making its error public, according to the rating agency."[55] Consequently, the following question should be arisen: could rating agencies be "reluctant" to review ratings because of the consequences they could have in order to keep their credibility? The fact that rating agencies' involvements are numerous creates multiple circularities that generate potential conflict of interest. **Consequently, one should wonder if it would be efficient to require rating agencies to disclose/communicate those circularities to market participants.**

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[50] Such disclosure could lead to an infringement of confidentiality requirements.

[51] In 2003, I considered that "the Commission has to deal with the definition of ancillary services. Are they assessment services that estimate the impact of an issuer's action (merger, acquisition, debt restructuring...) or large management services which propose management, strategic, process risk...? In other words, what are the ancillary services proposed by the rating agencies? Those questions need clear answers". *In* Raingeard (2003).

[52] *In* Bank for International Settlements (2005), see footnote 24.

[53] *In* Bank for International Settlements (2005), see footnote 24.

[54] *In* Bank for International Settlements (2005), see footnote 24.

[55] *In* U.S. Securities and Exchange Commission (2008b), see footnote 17.

“Approaches to improve credit rating agency oversight”

Before trying to define approaches that could improve credit agency oversight, one may wonder if regulatory authorities are credible for overseeing the rating industry.

1-Are regulatory authorities credible to oversee the rating industry?

In economic sciences, credibility is used to assess central bank policy. Credibility is ensured if central bank has clear goals (role, assignment), a strategy (tools) and an adequate structure to reach its goals. This framework may be applied to rating agencies[56] and regulatory authorities.

Until recently, it was possible to argue that the goal of the U.S. Securities and Exchange Commission was unclear. As stated above and in earlier comments, the NRSROs qualification suffers from several weaknesses. Furthermore, it seems that credit rating agencies “have more chances” to obtain the NRSRO’s qualification each time that regulatory processes are ongoing.

Decision of the Commission	Date	NRSRO Qualification Granted	Date
Concept Release	January 1994		
Proposed Rules	December 1997		
Special study	January 2003	DBRS	February 24, 2003
Concept Release	June 2003		
Proposed Rules	April 2005	A.M. Best	March 3, 2005
Proposed Rules	February 2007		
Final Rules	June 2007	Japan Credit Rating	September 24, 2007
		Rating and Investment Information	September 24, 2007
		Egan Jones	Decembre 21, 2007
		Lace Financial	February 11, 2008
Proposed Rules	July 2008	Real Point	June 23, 2008

If the recognitions of Japan Credit Rating and Rating and Investment Information seem logical as they are the results of the application of new rules, other qualifications do not seem to be the result of a consistent process. Indeed, in 2003, whereas the SEC studied the role of rating agencies, it recognised DBRS. One month before the SEC issued a proposed rule in 2005, the latter recognised A.M. Best. Less than one month before the proposed rules of 2008, the SEC qualified Real Point. Whereas the role of rating agencies in the current market turmoil were studied and call for regulation were expressed[57], the SEC recognised Egan Jones and Lace Financial.

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[56] For further details, see Lubochinsky and Raingeard (2008) and Raingeard (2008a, b).

[57] See for example: Financial Times, 2007, “Regulators to probe rating agencies”, November 9; Financial Times, 2008, “EU leaders take credit rating agencies to task”, January 30.

Consequently, one could wonder if the SEC recognised rating agencies because of calls for competition. Furthermore, are regulatory authorities and more particularly the SEC defined rules sufficiently forward looking? Finally, one should wonder if the "stop and go" regulation does not have adverse effect on the rating industry?

Concerning strategy and tools, it is essential to wonder if regulatory authorities and the U.S. Securities and Exchange Commission in particular have the good strategy[58] and the necessary means. Looking at this paper, it seems that regulatory authorities have to improve their credibility by learning from their experience. More particularly, one may regret that the potential conflicts of interest and the limits of credit rating in structured finance identified in 2005 were only considered, three years latter, once problems and limits arose. Consequently, regulatory authorities have:

- to impose rules that deal with potential conflicts of interest linked to ancillary services and tools that clearly reinforce the issuer influence;
- to create an authority/body that supervise/monitor the rating industry. It may help to prevent the development of mismanaged conflicts of interest and to address issues before they arise. For instance, the development of new rating products could create/increase potential conflicts of interest. The supervisory authority could monitor them thanks to a permanent dialogue with rating agencies and market participants. It may also ensure innovation in the rating industry and it may help to prevent the development of practices that could generate adverse effect on the rating industry. Possibly, one could also imagine that market participants turned to the supervisory authority in order to warn about unfair practices linked to credit rating agencies influence, unwilling cooperation or payment for rating, third-party analyst complaints…

Last, regulatory authorities, and the U.S. Securities and Exchange in particular, have to deal with key issues.

2-Some ongoing key issues

Is credit rating a public good[59]?

This problematic is very interesting and unfortunately very difficult to resolve. It leads to wonder if it is efficient to use rating for regulatory purposes. I have not definitive answer to this question. On the one hand, I guess that the use of ratings for regulatory purposes could be

[58] See also the comment related to the shift concerning the criteria of recognition made by the SEC, page 17.
[59] Credit rating is a public good when it is based on an "investor-paid model", as opposed to private goods which are based on a "subscriber-paid scheme".

useful as rating reduces informational asymmetry, contributes to improve market efficiency… as far as it is reliable and credible. On the other hand, the use of rating for regulatory purposes can give the illusion to investors that rating is a "perfect" assessment of credit risk or that rating agencies are equivalent.

One should wonder if the U.S. Securities and Exchange Commission has not changed its way of regulating rating agencies because of those latter elements. Until its new rule, it appeared to primarily rely on the reliability and credibility of rating agencies as the SEC (1997) claimed that NRSRO's recognition means that "the rating organization is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings"[60]. Its new rule (2007) drops the concepts of reliability and credibility of credit rating. This shift is difficult to understand and affect the credibility of regulatory authorities: **does the Commission drop them in order not to give investors the "illusion" of reliability and accuracy of credit rating? Does the Commission drop them in order not to give investors the "illusion" that the Commission guarantees the reliability and credibility of NRSROs?** If so, this shift may not be sufficient. It would have been more efficient to abandon the use of rating for regulatory purposes.
Furthermore, regulatory authorities, using the mapping approach for Basel II, can give the illusion that rating agencies are equivalent. For example, the French supervisory authority - the Commission bancaire - has listed the following ECAIs[61]: Banque de France, Coface, Dominion Bond Rating Services (DBRS), Fitch Ratings (Fitch), Japan Credit Rating Agency (JCR), Moody's Investors (Moody's), Standard & Poor's (S&P's). The mapping for the last five rating agencies is defined as follow:

External Credit Rating Assessment Institutions and Mapping in France for claims on corporate

ECA risk scores	Risk weight	Ratings of ECAIs				
		DBRS	**Fitch**	**S&P's**	**Moody's**	**JCR**
1	20%	AAA/AAL	AAA/AA-	AAA/AA-	Aaa/Aa3	AAA/AA-
2	50%	AH/AL	A+/A-	A+/A-	A1/A3	A+/A-
3	100%	BBBH/BBBL	BBB+/BBB-	BBB+/BBB-	Baa1/Baa3	BBB+/BBB-
4	100%	BBH/BBL	BB+/BB-	BB+/BB-	Ba1/Ba3	BB+/BB-
5	150%	BH/BL	B+/B-	B+/B-	B1//B3	B+/B-
6	150%	CCCH	CCC+	CCC+	Caa1	CCC+

Consequently, investors can consider that, due to this mapping approach, those rating agencies give "similar" credit assessments. But is there any equivalence among them? This concern has been already raised: Moody's (1994) claimed that "the SEC appears to have created in the capital markets merely the *illusion* of equivalence among the various agencies, their ratings and their rating standards. This illusion, Moody's believes, creates the

[60] *In* U.S. Securities and Exchange Commission (1997), see footnote 35.
[61] ECAI: External Credit Assessment Institutions.

opportunity for rating shopping (…). In addition, because of the manner in which the SEC uses NRSRO ratings in its regulations, investors may be led - fallaciously - to conclude that all NRSRO ratings of a certain level express opinions denoting equivalent levels of risk”[62]. As stated earlier, numerous researches demonstrate that differences between rating agencies exist.

If the Commission and other regulatory authorities want to drop the use of rating for regulatory purposes, the rating industry could be based only on a code of conduct (which may ensure its credibility) and the market could be the sole judge of the rating agencies’ performance. Nevertheless, the SEC (2003a) called for comment on the alternatives to the NRSRO designation, trying to “identify alternatives capable of achieving the regulatory objectives currently served by use of the NRSRO designation in certain Commission rules”[63]. “Most of the 46 commenters responding to the 2003 Concept Release supported retention of the NRSRO concept”[64].

Finally, the use of ratings by the Federal Reserve Bank in its unconventional monetary policy and, more particularly, in its Term Asset-Backed Securities Loan Facility program (2008), implies that credit rating remains a useful tool. Consequently, if regulatory authorities want to keep on using ratings in regulation, the criteria of reliability and credibility must be used in order to qualify rating agencies. Furthermore, they have to wonder if they do not generate adverse effects on the rating industry by not distinguishing rating agencies issuing “public goods” to those issuing “private goods”. **Indeed, by recognising NRSROs issuing “private goods”, does not the Commission discriminate between investors[65]? What could be the consequences for the rating system and market participants if Moody’s or Standard & Poor’s changes its fee model for a “subscriber-paid credit rating”?**

Different regulatory authorities, different approaches?

It seems that American and European views are quite different for two reasons. The first one is linked to the nature of credit rating in the United States: credit rating is an opinion. The second one is related to the regulatory options retained by authorities.

[62] *In* Moody’s Investors Services, 1994, “Response to Concept Release Regarding Nationally Recognized Statistical Rating Organizations”, U.S. Securities and Exchange Commission, 5 December 1994, Release n°33-7085; 34-34616; File n°S7-23-94.

[63] *In* Securities and Exchange Commission (2003a), see footnote 9. The SEC is still currently considering this issue. See for example, Casey K., 2009, “In Search of Transparency, Accountability and Competition: The Regulation of Credit Rating Agencies”, U.S. Securities and Exchange Commission, February 6.

[64] *In* U.S. Securities and Exchange Commission, 2005, “Proposed Rule: definition of Nationally Recognized Statistical Rating Organization”; Release n°33-8570; 34-51572; File n°S7-04-05.

[65] *i.e.* the discrimination between investors who have/have not the means to buy those “private goods”.

As stated earlier, rating agencies' policy seems to rely, in the United States, on the First Amendment - credit rating is an opinion - and the so-called "journalist's privilege". According to the European Parliament report (2004) and the "Call to CESR for Technical Advice"[66] (2004), it seems that European authorities have other view. For instance, Katiforis stated that "this analogy [rating agencies "act in a journalist capacity"] does not hold much water from the moment that ratings become part of the regulatory mechanism of financial markets, even against the better judgement of rating agencies."[67] The fact that a credit rating is an opinion in the United States raises a key question for the U.S. Securities and Exchange Commission: **is an opinion - the credit rating - that has regulatory power is still an opinion? The problematic must be addressed, whatever the answer is.**

The second concern is linked to the current recognition processes adopted by the SEC (2007) and the Commission of the European Communities (2008). On the one hand, the Rules defined by the U.S. Securities and Exchange Commission drop the concepts of reliability and credibility of credit rating. In fact, the Commission "only" requires "that an application for registration as an NRSRO contains credit rating performance measurement statistics"[68] and only looks for reliability in order to compare performance between NRSROs[69]. On the other hand, the Proposal for a regulation of the European Parliament and of The Council on Credit Rating Agencies seems to consider that credibility and high quality of ratings remain a key characteristic of rating. Indeed:

- in the "Legal elements of the proposal", it is stated that "the purpose of credit rating is to provide a credible and sound analysis of the credit risk"[70];
- in the "Comitology", it is claimed that the "main part of the proposed regulation introduces principles in order to ensure that (…) credit rating issued are of high quality"[71];
- in Article 1, it is stated that this "Regulation introduces a common approach to ensuring the high quality of credit ratings"[72].

[66] Committee of European Securities Regulators, 2004, "CESR's technical advice to the European Commission on possible measures concerning credit rating agencies", November.
[67] *In* European Parliament, 2004, "Report on role and methods of rating agencies", Committee on Economic and Monetary Affairs, A5-0040/2004, January.
[68] *In* Securities and Exchange Commission (2007), see footnote 33.
[69] "The Commission intends to continue to consider this issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of performance between NRSROs." *In* Securities and Exchange Commission (2007), see footnote 33.
[70] *In* Commission of the European Communities (2008), see footnote 46.
[71] *In* Commission of the European Communities (2008), see footnote 46.
[72] *In* Commission of the European Communities (2008), see footnote 46.

Needless to say that this European regulation raises two main questions: first, what does a credit rating of “high quality” mean? Does it mean that credit rating is reliable? If so, how to measure this reliability? Secondly, how is it possible to assess the credibility of credit rating?

Are those developments - two approaches to regulate rating agencies - efficient for the rating industry and market participants? I do not think so as it means that regulatory authorities do not have a clear and common understanding of the rating system.

Main conclusions

Are regulatory authorities, and more specifically the U.S. Securities and Exchange Commission, credible to regulate the rating industry? It is doubtful as:

- despite of numerous reports, codes of conduct, new rules…, the issues raised during the current financial crisis are broadly the same than the ones analysed in 2002 (see pages 3-6) ;
- the potential conflicts of interest and the limits of credit rating in structured finance were identified in 2005. The report of the Committee on the Global Financial System had not consequences on the rating industry and regulatory authorities deal with them, three years latter, once problems and limits arise (see pages 7-8);
- the lack of competition is partly the result of the regulation of the U.S. Securities and Exchange Commission as transparency and free access to market were not ensured (see pages 9-10);
- the strategy and goals of the U.S. Securities and Exchange Commission are not well-defined as the recognition of some NRSROs seems to be the result of political or public concerns and the main criteria of recognition has changed since 2007 (see pages 15, 17).

Are steps taken by regulatory authorities sufficient to increase significantly their credibility and improve the rating system? It is doubtful as:

- concerning competition, transparency and free access to market do not seem to be ensured (see page 13). It is necessary to wonder if an opinion - a credit rating - that has regulatory power is still an opinion (see page 19);
- concerning independence and conflict of interests: preliminary ratings should be prohibited; a clear strategy for advisory/ancillary services must be adopted and the potential adverse effects of circularities must be analysed (see pages 13-14).

What are the possible approaches to improve credit rating agency oversight? Regulatory authorities and in particular the U.S. Securities and Exchange Commission should:

- address issues linked to competition, independence and circularities raised above;
- adopt a learning by doing approach and create an authority/body that supervise/monitor the rating industry. It may help to address issues before they arise (see page 16);
- consider if rating is a public good and more specifically if it is efficient to use rating for regulatory purposes (see pages 17-18);
- have a global and common approach to regulate the rating industry in order to not create adverse effects on market participants (see pages 18-20).

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