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Credit Ratings Agencies Regulation

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Inside:

1. Introduction
2. The agencies
3. Reforms
4. The Regulatory structure

Contents

Summary **3**

1. Introduction **4**

2. The agencies **5**

3. Reforms **7**
3.1 EU Reforms 8

4. The Regulatory structure **12**
4.1 Report of the European Securities and Markets Authority 12

Summary

Credit rating agencies (CRAs) are used to assess the risk of a borrower's default, and its associated financial loss, in the sale financial products.

Credit rating agencies originally emerged as private companies offering investors considered opinions on the credit quality of borrowers. But while they continue to perform this function, their role has expanded over time. Credit ratings are now heavily hardwired into financial contracts, investment processes, and the regulatory framework.

Rating agency decisions therefore have potentially systemic consequences. Many policymakers and commentators have argued that the 2008 financial crisis was exacerbated by a combination of faulty ratings methodologies, conflicts of interest, and overreliance on ratings by banks, investors and regulators.

Credit rating agencies have therefore come under close scrutiny in recent years and new legislation has been passed in both the United States and Europe.

The agencies in Europe are regulated by one of the new European wide agencies – the European Securities and Markets Authority.

1. Introduction

Credit rating agencies (CRAs) are used to assess the risk of a borrower's default, and its associated financial loss, in the sale financial products.

Credit ratings agencies have had a pivotal role in the banking system, particularly over the last ten years. Their ability to rate, or price, securities composed of bundles of loans or other assets was crucial to the expansion of the securitised markets – especially with respect to residential mortgage backed securities. They were, however, criticised in the aftermath of the 2007 financial crash.

On empirical grounds, it is clear that they were simply wrong. The ratings given to mortgage backed securities were proven to be hopelessly wrong in most cases.

But, they were criticised on theoretical grounds too, for their lack of independence and self interest in lowering assessment standards in order to gain business. It is this latter aspect that has dominated views on how to improve this particular sector.[1]

[1] For comments on the causes of the breakdown of the ratings process and its consequences see, for example speech by Sir John Gieve, Deputy Governor for financial stability, in Bank of England Quarterly Bulletin 2008/Q1

2. The agencies

Credit rating agencies (CRAs) are used to assess the risk of a borrower's default, and its associated financial loss, in the sale financial products. Their primary function is to benchmark the likelihood of a debtor's default by providing a credit rating. They are not to be confused with what are normally described as credit reference agencies which do a similar job but for individuals. Firms such as Experian are an example of this latter type. This reduces the information imbalance arising between the issuer and investor where the former is better informed of the risks associated with a particular asset, and therefore helps the investor value an asset. Accordingly, high-quality ratings should be both accurate *and* stable over time, although inevitably some degree of trade-off exists.[2] These ratings, by virtue of their role in resolving information asymmetries and principal-agent problems, may be regarded as a quasi-public good.[3]

Both qualitative and quantitative methods based on information about the borrower and the structure of the product are used to determine a rating that falls on a sliding scale of creditworthiness, typically ranging from AAA (safest) to C (riskiest). CRAs are primarily employed to rate the creditworthiness of an issuer's bonds and securities; examples include government-issued bonds and mortgage-backed securities. A CRA provides ongoing credit ratings (e.g. of UK Treasury bonds) and initial ratings that are updated over time (e.g. for a new type of security). Currently, the three leading CRAs – Fitch, Moody's and Standard and Poor's – control 94% of the global market.[4]

CRAs are used in a wide variety of investment contexts. Of particular public relevance is their use in determining the cost of government borrowing (where bonds are issued and purchased by the market) and their influence on purchases by institutions like pension funds. The importance of CRAs in informing investment decisions has ensured that they have received strong criticism where their ratings have been inaccurate or have subsequently been significantly downgraded. One widely reported aspect of the crisis was the fact that up to 20 local councils made significant losses as they invested funds in Icelandic banks that continued to receive high credit ratings until just before their collapse.[5]

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2 The accuracy of the rating fundamentally rests on the CRA's ability to effectively predict potential discontinuities in the prospects of the product. Where this is likely to change over time the rating becomes unstable.

3 Pietro Cinquegrana, "*The Reform of the Credit rating Agencies: A Comparative Perspective*", ECMI Policy Brief No. 12/February 2009, p1

4 European Commission, "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, 12 November 2008

5 *Town halls fear for millions as Icelandic banks collapse*, The Guardian, 9 October 2008

Global criticism has been directed at CRAs for their failure to recognise the emergence of the 1997 East Asian and the 2007-09 financial crises.[6] In particular, their mistakes in calculating the risks associated with the complex mortgage-backed securities at the heart of the current crisis have been regarded as important contributing factors by some academics and the US House Committee on Oversight and Government Reform.[7]

6 Pietro Cinquegrana, " *The Reform of the Credit rating Agencies: A Comparative Perspective*", ECMI Policy Brief No. 12/February 2009, p1; Herwig Langohr and Patricia Langohr, *The rating agencies and their credit ratings*, 2008, pxiii

7 When junk was gold", *FT Weekend*, 18/19 October 2008; US House Committee on Oversight and Government Reform, Hearing on the Credit Ratings Agencies and the Financial Crisis, 22 October 2008

3. Reforms

In 2009 in the UK, the Turner Review[8] judged that credit rating agencies (CRAs) played an important role in the escalation of the financial crisis, despite having previously been adjudged "good" assessors of risk.

First, the Review suggested that the dramatic rise of securitisation accentuated some of the pro-cyclical biases inherent to the CRA model.

Secondly, the report noted that the stability and accuracy of ratings, especially in structured credit products, had significantly declined.

Finally, the Review suggested that the CRAs "may not have ensured that commercial objectives did not influence judgements on whether the instruments were capable of being rated effectively";[9] furthermore, products may have been structured to achieve a specific rating.

The Turner Review concluded that regulation "can address some of these problems, but only to a degree." Despite this problem, the report highlighted a number of ways in which regulation could be improved:

> As the [proposed EU] legislation currently stands credit rating agencies will be registered and financial regulators such as the FSA will play a supervisory role, coordinated at European level via colleges, which will ensure that appropriate structures and procedures are in place to manage conflicts of interest and to reinforce analyst independence from commercial revenue maximising objectives. This supervisory oversight should extend to requiring that rating agencies only accept rating assignments where there is a reasonable case (based on historical record and adequate transparency) for believing that a consistent rating could be produced. Given the global nature of capital markets, it is important that the European legislation is matched by agreement of compatible global standards, and the FSA is working through IOSCO to achieve this.
>
> Some measures can also be taken to reduce the inappropriate use of ratings. The rating agencies themselves have sought to improve communication relating to the purpose of ratings, stressing that they cannot be treated as carrying inferences for liquidity and price. Public policy should avoid unnecessary requirements for investing institutions to hold securities of a specific rating.[10]

The Review however, noted that it was "It is important, however, not to overstate the extent to which regulation can guard against the dangers of pro-cyclical hard wiring". Put simply, in boom periods everything looks safer and more secure which then justifies greater borrowing or debt issuance.

[8] FSA, Turner Review: A regulatory response to the global banking crisis, 18 March 2009
[9] Ibid., p77
[10] Ibid., pp78-79

3.1 EU Reforms

A general EU page on credit rating agencies featuring all the relevant documentation for revised regulation can be found here.

The EU commission had begun looking at possible new rules on CRAs before the crisis. In 2008 it published a consultation document on revised proposals and a new Regulation, (Regulation 1060/2009) was published in November 2009, but implementation was to be supplemented by 'centralised direct supervision'.

The Regulation introduced a registration procedure for CRAs to ensure that their ratings can be used by a wide range of institutions within the Community. The rules covered:

- Risks of conflicts of interest
- Quality of the ratings methodology
- They act in a transparent manner

The Commission press release on publication gave the following details:

> Credit rating agencies may not provide advisory services.
>
> They will not be allowed to rate financial instruments if they do not have sufficient quality information to base their ratings on
>
> They must disclose the models, methodologies and key assumptions on which they base their ratings
>
> They will be obliged to publish an annual transparency report
>
> They will have to create an internal function to review the quality of their ratings
>
> They should have at least three independent directors on their boards whose remuneration cannot depend on the business performance of the rating agency. They will be appointed for a single term of office which can be no longer than five years. They can only be dismissed in case of professional misconduct. At least one of them should be an expert in securitization and structured finance.[11]

The Regulation was given effect in the UK by *The Credit Ratings Agencies Regulations 2010* (SI 906/2010).

As the scale of the financial crisis became clear and the political concerns over the role the CRAs had in it grew, the Commission looked further into the need for more reform. In November 2010 it published another consultation paper on CRA regulation. This was an open public consultation and covered a range of issues:

- Overreliance on External Credit Ratings
- Sovereign Debt Ratings
- Enhancing Competition in the Credit Rating Industry
- Civil Liability of Credit Rating Agencies

[11] Europa website November 2008

- Potential Conflicts of Interest due to the "Issuer-Pays" Model

Of these, the proposals regarding sovereign debt became increasingly important as the sovereign debt crisis began to replace institutional default as the number one problem. A summary of responses to the consultation suggested that:

2.1 Enhance transparency and monitoring of sovereign debt ratings

There was a general consensus that sovereign issuers should not receive fundamentally different treatment to corporate issuers. There were calls from some governments and industry stakeholders for increased transparency regarding methodologies and publication of the full research reports underlying ratings, although a small number in this group opposed this idea. Some governments wished to propose a maximum period of time for the review of sovereign ratings. On the other hand, many respondents, across all stakeholder groups, including some rating agencies, was that sovereigns should not be treated significantly differently from other issuers, albeit a few stating that CRAs should be more alert to changes in all cases. The 3 days‟ notice measure, while supported by some Member States and regulators, caused to some others Member States and regulators concern, in particular because of risks of market abuse and conflict of interest issues.

2.2 Enhanced requirements on the methodology and the process of rating sovereign debt

In terms of ratings methodologies, there was strong support from various kinds of respondents for an improved transparency, and further calls to treat sovereign issuers in a similar way to corporate issuers. There was some support including from some regulators for postponing publication until close of business, but on the other hand, many respondents, including other regulators and Member States' considered this less effective when trading continues around the globe. Fewer respondents approached the issue of Member States not paying for ratings, with no real discernible trends of groups in favour or against: some felt that this would not reduce conflicts of interest, while others supported the measures and asked for a common European approach.[12]

The Paper also looks at the fundamental issue with the CRAs, namely the 'issuer-pays' model and looked at alternative models. Responses are summarized below:

5. POTENTIAL CONFLICTS OF INTEREST DUE TO THE "ISSUER-PAYS" MODEL

Respondents agreed that the "issuer-pays" model inherently contains conflicts of interest, although respondents of all kinds

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[12] EU Commission; Summary document *Overview of responses to Public Consultation on Credit Rating Agencies*,

also stated that it should be possible to manage and minimise these conflicts, and in addition, other models were also conflicted.

5.1. "Subscriber/Investor-Pays" model

Some financial firms and their industry bodies felt that increasing the cost of investment risked reducing demand for securities. Further respondents including competent authorities and governments noted that this model could reduce the independence of CRAs.

5.2. "Payment-upon-results" model

Some national authorities, government and trade bodies of financial firms were opposed to this idea and expressed scepticism as to the feasibility of implementing such a system. One trade body and one national authority were concerned that this model could lead to the erroneous notion of "right" or "wrong" ratings.

5.3. "Trading venues Pay" model

There was some support from the academic sphere for this model. However, among market participants, public authorities and interested third parties, this model was not a favoured option, especially in view of the large number of unlisted securities which would not be covered.

5.4. Government as Hiring Agent model

Governments responding to this question felt that this model had negative implications for conflicts of interest. There were also concerns about cost and how the model could be operated.

5.5. Public Utility model

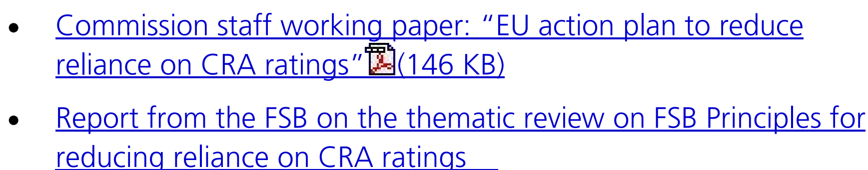
The trade bodies and public authorities responding to this option were concerned at the expense of such an option, and some of these had concerns about increasing overreliance and regarding conflicts of interest, particularly rating of sovereign debt during a crisis.[13]

The 2011 proposals came into force in June 2013. Various EU documents explain the impact:

- Press release
- Frequently Asked Questions

The intervening period had seen decisions on funding of the regulation, regulatory technical standards to be adopted by the regulators and the question of fines levied on CRAs for rule breaches.

Work continued on the theme of how to reduce reliance on Credit Rating Agency ratings generally:



- Commission staff working paper: "EU action plan to reduce reliance on CRA ratings" (146 KB)
- Report from the FSB on the thematic review on FSB Principles for reducing reliance on CRA ratings

And a feasibility study on alternatives to CRAs was launched in January 2015.

[13] EU Commission; Summary document *Overview of responses to Public Consultation on Credit Rating Agencies*

Further Regulations were published at the start of 2015 setting out Regulatory Technical Standards needed to implement key provisions of the Regulation on Credit Rating Agencies. These technical standards set out:

1. The disclosure requirements for issuers, originators and sponsors on structured finance instruments;
   - Text of the Regulation
2. Reporting requirements for credit rating agencies (CRAs) on fees charged by CRAs to their clients;
   - Text of the Regulation
3. Reporting requirements to CRAs for the European Rating Platform
   - Text of the Regulation

One practical impediment to some changes in the regulation of CRAs is the fact that their role is frequently enshrined in other rules or law. For example, to take a fairly widespread but small scale example, trustees of charities and other bodies may have the legal authority to only invest in certain rated securities as a way of limiting risk. At the other end of the scale, some of the regulatory capital charges are calibrated according to rated securities. Somehow, rating needs to carry on if there is not to be a breakdown in regulatory or commercial practice. A Bank of England summary of responses in *The case for a better functioning securitisation market in the European Union* included many comments about the ratings agencies. One was:

> 15. Regarding credit rating agencies (CRAs), respondents were most concerned with the interaction between ratings and regulation and the continued regulatory reliance on rating agencies. For example, regulatory capital charges are based on sovereign capped ratings, thereby creating a barrier to entry for peripheral issuers. Finally, the provision of ancillary facilities was viewed as a major risk and cost issue for securitisation, with a particular focus on the cost and availability of swaps.

4. The Regulatory structure

In 2011 the Commission agreed and published a new Regulation which established "an efficient and effective supervisory framework for credit rating agencies by entrusting a single supervisory authority with the supervision of credit rating activities in the Union".[14]

In May 2009, the European Commission announced as part of a much broader review of European financial supervision the establishment of several pan-European supervisory bodies:

European Systemic Risk Council: macro prudential supervision. Renamed the European Systemic Risk Board (ESRB)
European System of Financial Supervisors: monitoring individual financial institutions – micro-prudential supervision comprised of three European Supervisory Authorities (ESAs) which would have responsibility for monitoring CRAs.
European Securities and Markets Authority (ESMA): supervisory powers over "entities with Community wide reach"

An ECOFIN meeting in December 2009 confirmed the establishment of an ESMA but restricted its scope to CRAs. In June 2010 the EU Commission proposed an amendment to the 2009 Regulation which would formalise ESMA's role in supervising the agencies.[1]

Hence, the body responsible for CRA monitoring is the ESMA and all agencies established in the EU must register with it. As at 12 December 2014, 40 agencies are registered, although many of these are national agencies of one of the big groups such as Moody's or Fitch.[15]

ESMA's powers, given it in December 2010, include fines of 20% of an agency's turnover, carry out raids on premises and 'force agencies to justify their ratings'.[16] Documents relating to the regulation of CRAs can be found on the ESMA website here.

4.1 Report of the European Securities and Markets Authority

In March 2012 the European Securities and Markets Authority (ESMA) published its first Report on the Supervision of Credit Rating Agencies by which time all the main groups had been registered. ESMA had published 'regulatory technical standards' for the CRAs to follow, for example on:

> a) information to be provided by CRAs for applications for registration and certification, b) information provided by CRAs to ESMA through the CEREP platform c) the assessment of the compliance of the rating methodologies, and d) the content and format of ratings data periodic reporting to be requested from CRAs for the purpose of ongoing supervision by ESMA[17]

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14 Regulation (EU) No 513/2011
15 ESMA website
16 Europolitics 16 December 2010, 4105
17 ESMA; *Report on the Supervision of Credit Rating Agencies*; March 2012

The Report criticised the CRAs for the lack of transparency in their decision making; the speed with which assessments were made; high staff turnover; and develop Board level governance procedures which would ensure that the CRAs met the Regulation requirements. It concluded:

> This report provides the results of ESMA's first examination on the three groups of registered CRAs.
>
> ESMA has identified several shortcomings and areas for improvement in CRAs internal policies and procedures and addressed specific recommendations to the CRAs in the following areas:
>
> - recording of internal meetings;
> - timing of the distribution of documents ahead of Rating Committees;
> - adequacy of resources devoted to the analytical business;
> - internal control functions and Independent Directors;
> - disclosure of rating methodologies;
> - process for the disclosure of ratings actions; and
> - IT environment.
>
> As of the date of this document, ESMA has not determined whether any of the observations constitutes a breach of the provisions of the Regulation. ESMA will follow- up on the observations related to the individual CRAs in the first half of 2012.[18]

In the equivalent document published a year later ESMA commented:

> At the same time, ESMA believes that CRAs have not yet sufficiently embedded all the main requirements of the Regulation into their organisations. Given the continued importance of credit ratings in the financial markets and the inherent conflicts of interest associated with commercial drivers and the business models applied in this industry, ESMA believes that further improvements in the following areas are necessary:
>
> - the consistent application and comprehensive presentation of rating methodologies;
> - the empowerment and resourcing of analytical and control functions;
> - the monitoring and surveillance of ratings; and
> - the reliability of IT infrastructures.

[18] Ibid p15

> ESMA will also focus on these matters as part of its supervisory work plan for 2013.[19]

An accompanying press release noted:

> "While CRAs have made progress in meeting the regulatory requirements on integrity, transparency, responsibility and good governance, they have not sufficiently embedded in their organisations those changes necessary to address the concerns about the conflicts inherent in CRAs business models.
>
> "Considering the continued importance of credit ratings in financial markets it is extremely important that CRAs identify and remedy those issues in their businesses which may undermine the independence, objectivity and the quality of credit ratings. This will contribute to building confidence in the transparency and smooth functioning of EU financial markets while ensuring a high level of financial consumer protection."[20]

By July 2013 ESMA had launched another consultation into a review of the existing regulation. This consultation was to inform the drafting of new regulatory technical standards covering:

- disclosure requirements on structured finance instruments (SFIs);
- the European Rating Platform (ERP); and
- the periodic reporting on fees charged by CRAs.

The relevant consultation paper can be found here. The outcome of this consultation was published in June 2014.[21]

At the end of 2013 ESMA published a Q&A on the implementation of the CRA regulation - a document they intend to update periodically. All documents published by ESMA pertaining to CRAs can be found here.

The ESMA is a good source of material for ongoing technical and market information about European CRAs. Its website can be found here.

[19] ESMA; *Credit Ratings Agencies Annual Report 2012*; March 2013
[20] ESMA *Press Release* 18 March 2013
[21] ESMA: *Final Report: Draft Regulatory Technical Standards under the CRA3 Regulation*

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