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Credit Rating Agencies (CRAs)

The EU Regulatory Framework Assessment

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Abstract

Credit Rating Agencies (CRAs) can provide a valuable service for the capital markets if they deliver a credible assessment of the relative probability of default of credit financial instruments that enables investors to reduce the information asymmetry. CRAs have had an indisputable role in accentuating the crisis, and preventative regulation of CRAs has emerged as crucial and necessary, becoming a priority in all high-level policy decisions in Europe and worldwide. This thesis will first present a brief overview, defining credit rating concept, giving an account on market leaders and history of CRAs. Then the researcher critically examines the regulatory approach adopted by the EU since the first calls to regulate CRAs in Europe. Some of the US initiatives will also be reviewed in order give a more comprehensive assessment for regulating the credit-rating activity as a whole. As the research progresses, it becomes abundant, that CRAs cannot predict whether a particular default occurs, thus, perhaps over-reliance on CRAs is one the main causes why CRAs bolster the financial disruptions. However, there are many ethical problems to overcome in relation to CRAs: conflict of interest, moral hazard, information asymmetry, and even when some are eliminated, for instance free rider problem may arise. There is no ideal solution for CRA business model – the existing model wisely combines issuer-pays and investor-pays approaches. As for regulation, a European CRA has been considered, but feasibility analysis has shown such may be costly or even pose another ethical threat. Newly created ESMA has to gain more experience to continue tackling CRAs issues.

Keywords	Credit Ratings Agencies (CRAs), credit rating, ESMA, EBA, EIOPA, IOSCO, SEC, FSB, BCBS, conflict of interest, Enron, Issuer-Pays model, EU regulatory framework.

Contents

1 Introduction

1.1 Credit Rating and Credit Rating Agency (CRA)

As Langohr pointed out in his publication *"The Rating Agencies and their Credit Ratings, What They Are, How They Work and Why They Are Relevant"*, there is no industry definition or standard to describe credit ratings, and no trade association of Credit Ratings Agencies (CRAs). During the 2003 – 2006 institutions worldwide attempted to define the credit rating concept (Langohr, 2008).

At a global level, securities supervisors grouped in the International Organization of Securities Commissions (IOSCO) had set out various concepts in the IOSCO Code, such as those of "rating agency" and "rating". Despite the voluntary nature of the IOSCO Code, these definitions implied international standardisation and were adapted by European legislators (Garcia, 2012). Both IOSCO and the Committee of European Securities Regulators (CESR)[1], claim a "credit rating – is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations. They are not recommendations to purchase, sell, or hold any security" (Langohr, 2008).

The US Securities and Exchange Commission (SEC) defines a Credit Rating Agency as "a firm that provides its opinion on the creditworthiness of an entity and the financial obligations … issued by an entity. Generally, credit ratings distinguish between investment grade and non-investment grade (SEC, 2013).

In the Official Journal of the EU in 2006 European Commission (EC) states that CRAs issue opinions on the creditworthiness of a particular issuer or financial instrument. They assess the likelihood that an issuer will default either on its financial obligations generally or on a particular debt or fixed income security (EC, 2006).

According to the memo on New Rules on CRAs, published in Brussels, 16 January 2013, the EC clarifies the concept once again: a credit rating is an opinion issued by a specialised firm on the creditworthiness of an entity or a debt instrument. A credit rating agency (CRA) is a service provider specialised in the provision of credit ratings on

[1] On January 1, 2011, the Committee of European Securities Regulators (CESR) officially became the European Securities and Markets Authority (ESMA).

a professional basis (EC, 2013a).

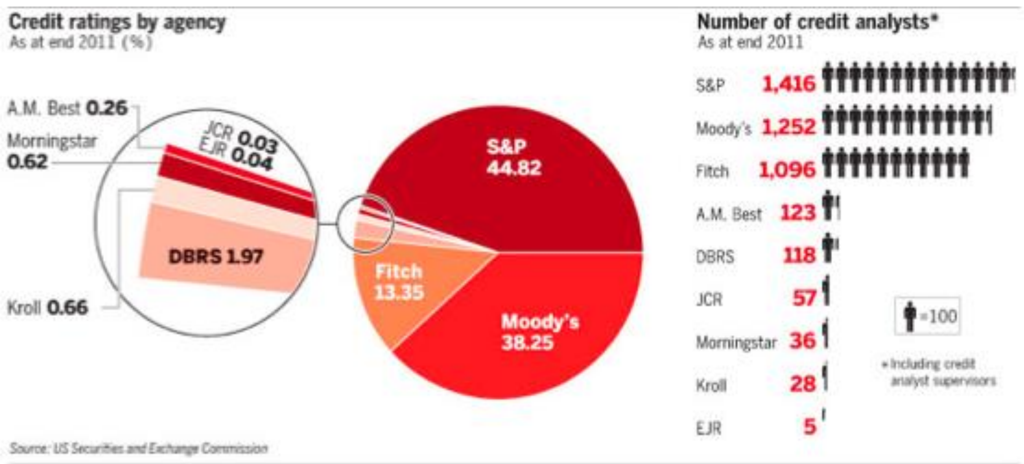
As claimed by the Bank of England Finacial Stabilty Report of 2007, there are at least three essential tasks CRAs serve the financial system and should retain:

> (i) Ratings can help mitigate the fundamental information asymmetry in capital markets between investors and firms seeking external financing.
> (ii) Ratings can be a useful mechanism to solve some principal agent problems.
> (iii) Ratings can be used to solve collective action problems between dispersed bond investors (Bank of England, 2007).

1.2 The Big Three

A more objective interpretation of credit rating concept may be formulated by reviewing how CRAs represent themselves (Langohr, 2008). The largest three rating agencies are Standard & Poor's, Moody's and Fitch. They cover approximately 95% of the world market. Smaller rating agencies make up the remaining part (EC, 2013a).

Market Share by Credit Rating Agency **(Figure 1)**



The largest market shares are allocated amongst S&P (44,82%), Moody's (38,25) and Fitch (13,35%).

Original source: US Securities and Exchange Commission (SEC) website, http://www.sec.gov/ (Accessed 18 Apr. 2013)
Secondary source: Foley, Stephen *"Rating agencies: Outlook unchanged."* Financial Times, 14 Jan. 2013, 25 Mar. 2013 <http://www.ft.com/intl/cms/s/0/38d48444-5e3d-11e2-a771-00144feab49a.html#axzz2QnNFC8lY>.

Many studies have concluded, that this market is a natural oligopoly (CESR, 2005) as the nature of the CRA market makes it complicated for new CRAs to succeed and for existing CRAs to conquer a larger market share. Issuers prefer ratings from reputable

CRAs, while investors respect CRAs with a history of accurate and timely ratings – thus it results in a lack of competition (Garcia, 2013).

Credit Rating Definition by the Big Three CRAs (Table 1)

Fitch Ratings Definition	**Moody's Ratings Definition**	**Standard & Poor Ratings Definition**
"Fitch Ratings' credit ratings provide an *opinion* on the *relative* ability of an entity to meet financial commitments… Credit ratings, as opinions on *relative* ranking of vulnerability to *default*, do not imply or convey a specific statistical *probability of default*, notwithstanding the agency's published *default* histories that may be measured against ratings at the time of *default*. Credit ratings are opinions on *relative* credit quality and not a predictive measure of specific *default probability*." (Fitch, 2013).	Moody's rates and publishes *independent credit opinions* on fixed-income securities, issuers of securities and other credit obligations… Investors use Moody's ratings to help price the credit *risk* of fixed-income securities or debts they may buy, sell or lend." (Moody's 2013).	"A credit rating is Standard & Poor's *opinion* on the general *creditworthiness* of an obligor, or the *creditworthiness* of an obligor with respect to a particular debt security or other financial obligation." (Standard & Poor's 2013a).

The table above demonstrates the variation between each CRAs definition. Fitch stresses that ratings are relative and concerned with default. Fitch definition emphasizes the distinction between the probability that default occurs and the potential loss to the investor. Moody's accents on the independence of its opinion, which deals with credit risk. S&P ratings incorporate creditworthiness. The big three CRAs all describe a credit rating as an opinion about whether the issuer of a fixed income security will pay amounts due on time and in full. The common conception is that ratings attempt to analyse the issuer's likelihood to default (Fitch, Moodys, Standard & Poor's 2013).

1.3 Rating Category

CRAs rank securities and issuers on a relative scale. For example, Fitch and S&P use AAA, AA, A, BBB, BB… while Moody's goes with Aaa, Aa, A, Baa, Ba… CRAs also use modifiers (such as '+' or '−'; '1, 2, or 3') appended to the rating categories in order to denote relative status within the major rating categories. The combination of a category (for example 'A') and a modifier (such as '+') constitutes a 'notch' in the rating scale (for instance 'A +'). A change of a rating means assigning a credit rating a different notch in the rating scale. Categories do not reflect absolute measures of risk, only that securities classified in a higher category have higher quality than those in the categories below (Garcia, 2012).

1.4 Rating Types

ESMA has defined three broad categories of rating types that have been broken down into the following segments:

- Corporate ratings: financial institutions – including banks, brokers, and dealers – insurances, other corporate issuers;
- Structured finance ratings: asset-backed securities (ABS), residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDO), asset-backed commercial papers (ABCP);
- Sovereign and public finance ratings: sovereign, other local governments, municipalities, supranational organizations, and public entities (Garcia, 2012).

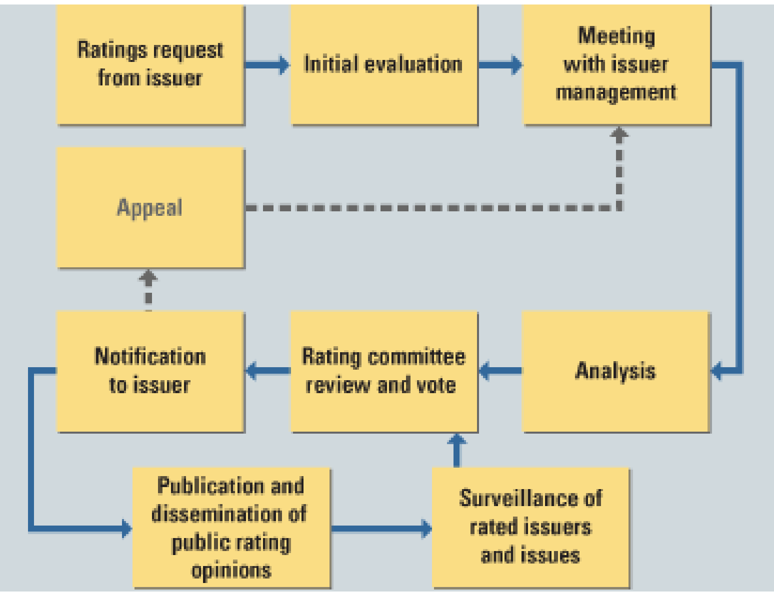
1.5 Credit Assessment Methodology

CRAs differ in their methodologies and models employed to arrive at the rating. Some base their ratings principally on default probability, whilst others use the concept of expected loss. In relation to the EU, Article 8.3 provides that a CRA shall use methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing (Garcia, 2012).

1.6 Credit Rating Process

A small number of CRAs use the model-driven approach, focusing on quantitative data that they incorporate into a mathematical model to produce their ratings. In analyst-driven system, credit rating professionals conduct a review of the financial performance, policies, and risk management strategies as well as of the business and economic environment in which the issuer operates. In addition to evaluating financial data, credit analysts typically weigh qualitative information (Standard & Poor’s, 2013b).

Analyst-Driven Rating Process by Standard & Poor's **(Figure 2)**



Standard & Poor's website, *About Credit Ratings* Section, *"What Credit Ratings Are & Are Not."* 19 Apr. 2013, <http://www.standardandpoors.com/aboutcreditratings/Images/SP_RatingsProcess_large.gif>.

1.7 The Rise of CRA Era

Credit rating as a profession dates back to the beginning of the 20th century in the USA. It is also where regulation of this business first developed, and also where the root of the current crisis lies (Papaikonomou, 2010).

Three types of businesses emerged in the 19th century: the specialized financial press, credit reporting agencies and investment bankers. One of the first publications was The American Railroad Journal, started in 1832, which was transformed in 1949 into a publication for investors in railroads by Henry Poor. In the meantime Poor set up his own firm, collecting statistics on US railroad companies. The company published the results annually as the Manual of the Railroads of the US. One of the first credit reporting agencies, founded in 1841, was The Mercantile Agency, selling its service to subscribers (Sylla, 2002).

In 1909, John Moody initiated agency bond ratings in the US, which was a pioneer to include credit risk analysis for rating purposes. Originally, this only covered the bonded debt of the US railroad companies (Sylla, 2002).

Post war prosperity of 1960s, made CRAs relatively unimportant. CRAs expanded rapidly again during the 1970s as the Bretton Woods System collapsed and a new era of financial globalisation emerged together with liberalisation of capital flows and redistribution of OPEC wealth, resulting in a greater number of sovereign states and private corporations, issuing bonds. However, the agencies shifted to issuer-pays model. This was the point when SEC in 1973 designated certain CRAs as Nationally Recognised Statistical Ratings Organisations (NRSROs), raising further concerns of NRSROs "abusing" their power for regulatory purposes (Sylla, 2002).

1.8 Calls to Regulate CRAs Worldwide

As Langohr remarks, CRAs can't foresee if a particular default occurs. When catastrophic default disasters struck South-East Asia in 1997, the US in 2001 – 2002, and Europe in 2002 – 2003, the CRAs only spotted them at the last minute. Papaikonomou wrote "the regulation of credit-rating activity and CRAs has become a top priority on all regional and international policy makers"…since the outbreak of the crisis. The topic has also been a recurring feature in most financial market experts' reports and recommendations published during the last two years [2008-2010]" (Papaikonomou, 2010).

CRAs started to adopt a voluntary code of conduct worldwide. In April 2002, the European Commission (EC) mandated the Economic and Financial Affairs Council (ECOFIN) to analyze the issue of CRAs (EC, 2006). Later, in December 2005 the EC produced Communication on CRAs (Langohr, 2008). Across the Atlantic, the US CRA Reform Act of 2006, established a legal framework for the registration of NRSROs (aimed to improve ratings quality by fostering accountability, transparency and competition) actually empowering the SEC with greater monitoring authority. Papaikonomou observes the SEC had adopted additional rules to date rulemaking developed for transparency and to decrease the reliance on NRSROs (Papaikonomou, 2010).

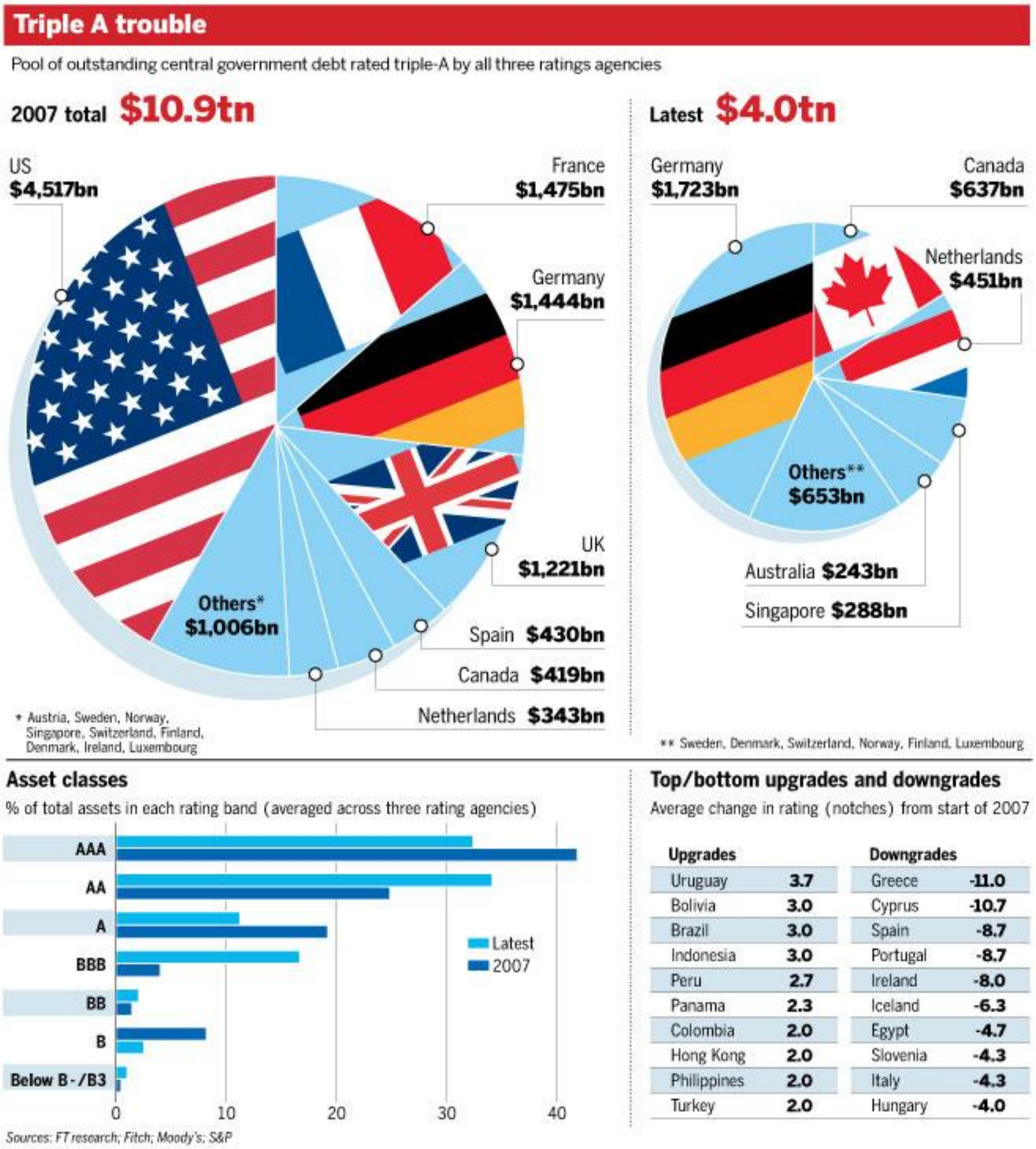
Papaikonomou continues – the role of CRAs in the crisis, the unsatisfactory self-regulation and market failure, all had bolstered the EC to propose a regulation on CRAs in November 2008. This decision was consistent with the March 2008 "ECOFIN roadmap", one of whose four main objectives was to "investigate structural market issues, such as the role played by CRAs and the originate and distribute model". However, the author is not entirely convinced that those hectic changes to the EU CRA legislation are sufficient to address the problems (Papaikonomou, 2010).

2 Literature Review

2.1 Periodicals and CRAs

Worthless AAA ratings given by the Big Three (Standard & Poor's, Moody's, and Fitch Group) have been aired in the news headlines as an attempt to unveil the roots of the financial turmoil.

Pool of outstanding debt rated triple-A by all three agencies (Figure 3)



Financial Times, *Crisis-hit Europe dominates rating losers, <http://www.ft.com/intl/cms/s/0/2caf9a06-9622-11e2-9ab2-00144feabdc0.html#axzz2OgunTUqP>* (accessed 29 March 2013).

The figure above, *Shifts in the Global Credit Ratings Map* published by the FT's analysis, discloses:

> How – unlike previous financial crises since the second world war – much of the damage wrought by volatile banking or financial systems and weak public finances has been focused on advanced western economies, especially in Europe. At the bottom is crisis-hit southern Europe, including Greece, whose creditors last year faced steep losses under the country's debt restructuring" (Atkins, 2013a).

2.2 Langohr's Perspective on Credit Rating Concept

Langohr gives a pragmatic view on a concept of a credit rating in his publication *"The Rating Agencies and their Credit Ratings, What They Are, How They Work and Why They Are Relevant"*. As the author wrote, there is no industry definition or standard to describe credit ratings, and no trade association of CRAs. He suggests considering definitions given by various international bodies related to CRAs (Langohr, 2008).

2.3 Papaikonomou's Perspective – Need for a Paradigm Shift

Papaikonomou clarifies a concept of a paradigm shift as: "a complete change in way of thinking or in a belief system that allows the creation of a new condition previously thought impossible or unacceptable". The focus of his paper is the new EU rules on CRAs (Papaikonomou, 2010).

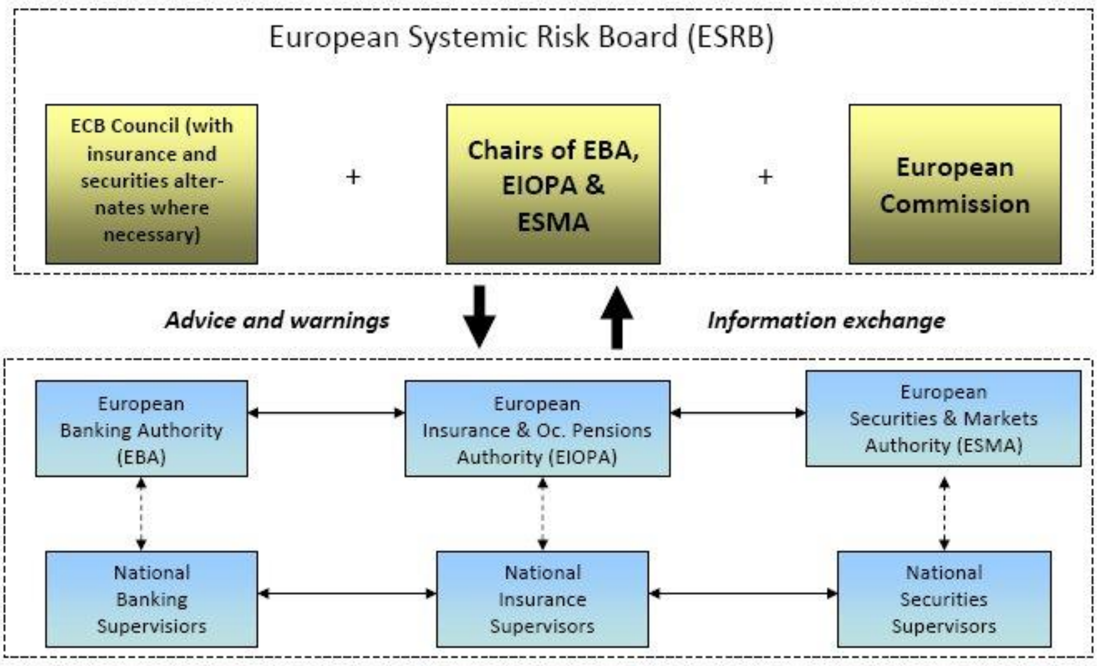
2.4 Garcia's Perspective on Regulation of CRAs in the EU

Garcia's publication explores weaknesses of CRAs in relation to asset-backed securities' ratings and concludes with the policy discussions around the ratings of EU sovereign bonds. The book discusses other models as alternatives to the issuer-pays model to address conflicts of interest and enhance competition, including the creation of a public European rating agency (Garcia, 2012).

2.5 European Supervisory Framework

Figure 3 represents European Systemic Risk Board.

European Systemic Risk Board (ESRB) (Figure 4)



ESMA website, *European Supervisory Framework*, <http://www.esma.europa.eu/page/European-Supervisory-Framework> (accessed 29 March 2013).

The European supervisory framework incorporates:

- The European Systemic Risk Board (ESRB), which monitors and assess potential threats to financial stability.
- The European Securities Markets Authority (ESMA), based in Paris.
- The European Banking Authority (EBA) based in London.
- The European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt (ESMA, 2013b).

2.5.1 The European Commission (EC)

As the European Commission (EC) is the driving force in proposing legislation (to Parliament and the Council), it holds an essential role when it comes to CRAs regulations.[2]

2.5.2 European Securities and Markets Authority (ESMA)

On 7 December 2009, the EU Regulation 1060/09 on CRAs entered into effect. Following the announcement of the creation of ESMA[3], the CRA Regulation was revised in

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[2] Most of CRA related communication is published on the EC's website <http://ec.europa.eu/internal_market/rating-agencies/index_en.htm>.

December 2010 [to give] ESMA an exclusive responsibility for the registration and supervision of CRAs in the EU, in cooperation with EBA, EIOPA and IOSCO. ESMA contributes to the work of the European Systemic Risk Board (ESRB), by providing data and undertaking stress tests in close co-ordination with the fellow ESA's and the ESRB (ESMA, 2013a).

2.5.3 The European Banking Authority (EBA)

The European Banking Authority (EBA) has officially come into being as of 1 January 2011 and has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS). The EBA safeguards public values: the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors (EBA, 2013).

2.5.4 The European Insurance and Occupational Pensions Authority (EIOPA)

EIOPA is the European Insurance and Occupational Pensions Authority. Article 9 of Regulation 1094/2010 establishing EIOPA requires EIOPA to take a “leading role” in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market (EIOPA, 2013).

3 Research Plan

Despite the existence of CRAs for almost a century, their role has become ever more ambiguous in the past two decades. Business schools sometimes bring up Enron Scandal as a role model – where unethical decisions can destroy shareholder wealth (Elizabeth Schaumann, 2010). After a collapse of Enron and a recent financial crisis the reputation of CRAs has undergone a significant turmoil.

CRAs monitoring bodies number has been growing and those have been exceptionally active in developing new regulations and agendas. This conveys evidence: the system in need of a considerable change is being continuously altered by formulated organisations. Brooke (2012) states that CRAs were not regulated in Europe until year 2011,

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[3] On January 1, 2011, the Committee of European Securities Regulators (CESR) officially became the European Securities and Markets Authority (ESMA).

when the EU began requiring them to register with ESMA. However, regulatory measures imposed by European Securities and Markets Authority (ESMA) provoked fierce objections:

> The BVI [which represents the German asset management industry] said it was "stunning" that Esma had already drawn regulatory conclusions for Ucits in a number of areas where political debate had not properly started. (Flood, 2012).
>
> Both the BVI and Aima [Alternative Investment Management Association] expressed concerns about Esma's new rules governing strategy indices used by growing numbers of Ucits to track the performance of hedge fund managers. (Flood, 2012).

Given the research question of this thesis CRAs – An Analysis of European Regulatory Framework, an overview on the European Union's unregulated background of CRAs will be presented followed by recent regulatory framework in the EU and to some extent – international initiatives – coupled with suggestions for further developments to enhance credit ratings accuracy.

Relevant information for this research subject is available in public libraries as well as online databases: Ebrary, ProQuest, SpringerLink, Oxford Analytics, Google Stats, Periodicals amongst others. There are textbooks covering CRAs, quite a few articles and plenty of websites of relevant regulatory bodies. Mainly qualitative data will be reviewed and to some extent quantitative data derived from secondary sources will be analysed.

4 Analysis of the EU CRA Regulation in International Context

4.1 International Bodies

After Asian crisis in the late 1990s or the Enron bankruptcy in 2001, The International Organization of Securities Commissions (IOSCO) Technical Committee, on its own initiative or at the request of the Financial Stability Forum (FSF) and the Committee of European Securities Regulators (CESR) – [now ESMA], thoroughly reviewed CRA activity. In this context, the CESR (ESMA) and The European Securities Markets Expert Group (ESME) delivered reports to the EC on the activity of CRAs. These developments were reflected in a European Parliament's resolution on CRAs of February 2004, and EC's Communication (EC, 2006). Meanwhile, IOSCO and CESR (ESMA) continued reviewing CRAs activity and code compliance (Papaikonomou, 2010).

4.1.1 The International Organization of Securities Commissions (IOSCO)

Globally, the International Organization of Securities Commissions (IOSCO) includes over 100 securities commissions (IOSCO, 2012). The counterpart of the SEC in the EU is the ESMA (Scalet, 2012).

In September 2003, IOSCO Principles were published for securities regulators, CRAs, and market participants to improve investor protection, fairness, efficiency and transparency; and to reduce systemic risk. When developing the principles, IOSCO acknowledged that CRAs were regulated differently in each jurisdiction, and allowed CRAs to decide on the best way to give effect to the principle (Garcia, 2012).

In December 2004 IOSCO developed "*Code of Conduct Fundamentals for Credit Rating Agencies*". In May 2008, the 2004 code of conduct was updated in order to address the problems that emerged in the credit markets (IOSCO, 2008a). In March 2009, the IOSCO reviewed its code implementation throughout the world (IOSCO, 2009).

The Code Fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors, issuers and the public (IOSCO, 2008b).

4.1.2 Basel Committee on Banking Supervision (BCBS)

The Basel Committee on Banking Supervision (BCBS), an international forum for the world's leading banking supervisors (McVea, 2010), consists of the Central Bank Governors of the Group of 10 nations (Scalet, 2012).

The Basel II Framework comprises a set of standards for establishing minimum capital requirements. It was prepared by the BCBS that developed the first standard in 1988 (Garcia, 2012). As announced in June 2004, BCBS under the supervision of the Bank for International Settlements (BIS), assigned credit ratings a central role (Langohr, 2008).

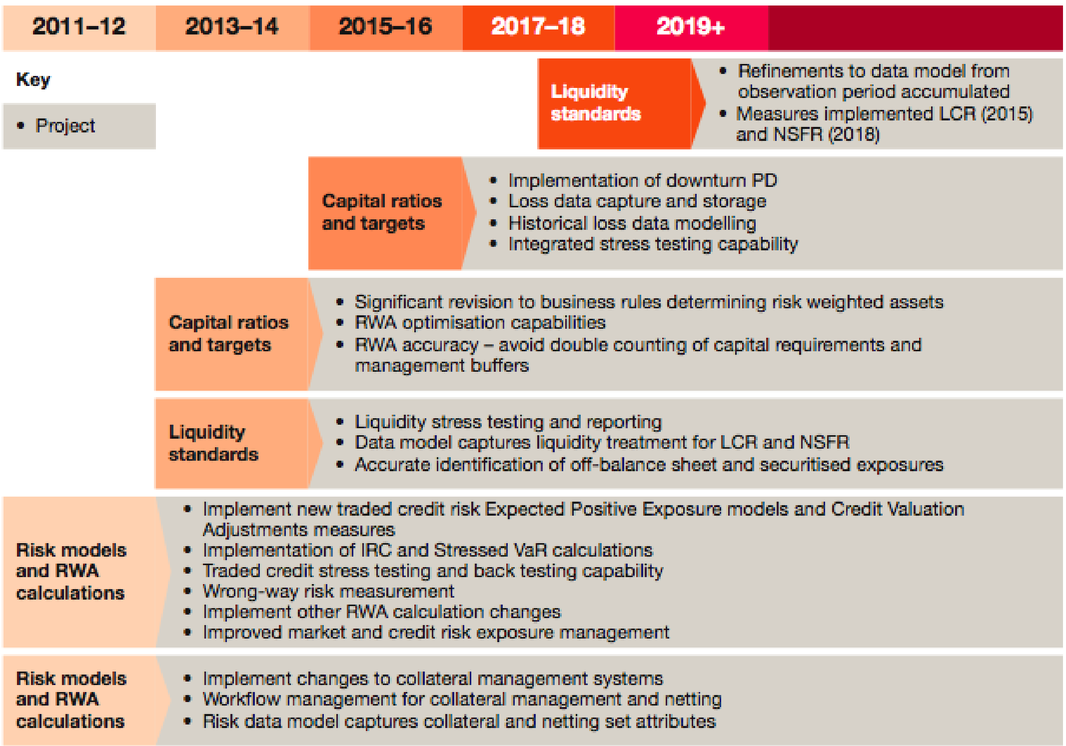
BCBS permits banks to use ratings from certain accredited CRAs to determine minimum credit risk capital requirements under Pillar I of the Basel Capital Accord (Basel

II). In the EU these principles have also been embedded in legal rules as part of the EU's Capital Requirements Directive 2006/48/EC (CRD) (McVea, 2010). In the same way, Garcia outlines the CRD is the European implementation of the Basel II framework (Garcia, 2012).

The Basel II framework provides tables that attribute different risk weights to each rating grade issued by a recognized External Credit Assessment Institution (ECAI). As stated by the EBA's guidelines on ECAIs, the ECAI recognition for capital purposes does not constitute a form of regulation of ECAIs or a form of licensing of rating agencies to do business in the EU (Garcia, 2012).

A figure below discloses Basel III implementation timeline.

Basel III Implementation Timeline **(Figure 5)**



Source: PwC

Barfield, Richard; Dawson, Symon; Loy, Vincent *"Basel III and beyond: Don't make data quality the elephant in the room."* PwC report, 2012, <www.pwc.co.uk/banking>.

As part of the global initiatives endorsed by the FSB and the G-20 leaders, BCBS has advocated a single set of global financial standards Basel III, as part of a more comprehensive response to the financial crisis of 2008 (Scalet, 2012). The text of this reform called the Basel III Framework, was issued by the BCBS in December 2010. Basel III complements the Basel II and Basel I frameworks but does not replace them (Garcia, 2012).

4.1.3 G-20 – The Group of Twenty

The Group of Twenty Finance Ministers and Central Bank Governors (G20) is the premier forum for international cooperation on the global economy and financial agenda.

The objectives of the G20 refer to:

1. Achieve global economic stability, sustainable growth;
2. Promote financial regulations to reduce risks and prevent future financial crises;
3. Modernizing international financial architecture (G-20, 2013a).

4.1.4 Financial Stability Board (FSB)

The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G7 Finance Ministers and Central Bank Governors. In November 2008, the Leaders of the G20 countries called for a larger membership of the FSF (FSB, 2013a). The FSB has been established to coordinate the work of national financial authorities internationally (FSB, 2013b).

4.1.5 Securities and Exchange Commission (SEC)

The mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. CRAs registered as such with the SEC are known as Nationally Recognized Statistical Rating Organizations (NRSROs) (SEC, 2013).

4.2 CRA Criticism and Ethics

4.2.1 Self-regulation

Papaikonomou describes self-regulation of CRAs, as remedial initiatives towards correcting their own practices, adjusting their governance, e.g. by separating credit-rating activity from the provision of other services, modifying their methodologies or improving transparency. Remarkable credit-rating downgrades of 2007 and throughout the unfolding of the crisis, with historical downgrades hitting especially structured product ratings, demonstrate the over-optimism of CRAs in carrying out their own monitoring (Papaikonomou, 2010).

4.2.2 Enron Scandal

Fitch, Moody's, and S&P came under intense criticism after the collapse of Enron in December 2001 (Gaillard, 2012). Harry McVea confirms that the most vivid illustration of CRA failures in the pre-crisis era was in relation to Enron, where Enron's credit rating was only downgraded a few days before the company filed for bankruptcy, despite the fact that its difficulties were widely known (McVea, 2010).

Andrew Hill's article published in Financial Times, *"Enron: see no evil, hear no evil, speak no evil"*, observes:

> "When the CRAs downgraded Enron's debt to junk in late November 2001 (they had been holding off in the hope a rival group might buy the energy trader; many Wall Street analysts still rated the company a "buy" or "strong buy"), it was bust within days" (Hill, 2011).

CRAs provide access to global capital markets by helping a company to identify its place in the distributions of its business. CRAs could be regarded as gatekeepers of the capital market's arena (Langohr, 2008). The failure of the gatekeepers to detect Enron's collapse could be reasoned by the "general deterrence" and "bubble market" hypothesis. A concept of general deterrence is explained as the decline in the expected liability costs that faced auditors who were considering whether or not to acquiesce in aggressive accounting policies favoured by managers. While the bubble market concept emphasizes that in an atmosphere of market euphoria gatekeepers have less relevance and, consequently, reduced leverage with their clients (Coffee, 2004).

Langohr calls the major bankruptcies similar to Enron as a period of "financial disintermediation", whereby major corporations relied increasingly on the bond market to raise capital. The shift in the 1980s away from defined-benefit retirement plans to company-administered defined contribution plans, increased importance on the role of pension fund managers, who relied on the judgments of CRAs (Langohr, 2008).

Prior to the current crisis, there had been about one ratings crisis every three years in the past twenty-two years (Sy, 2009). Calls for regulating the credit-rating industry date back to before the Asian crisis in the late 1990s or the Enron bankruptcy in 2001. It is the point when its investment-grade debt became questionable. Nevertheless, financial markets worldwide continued to rely largely on self-regulation. Papaikonomou is convinced, that self-regulation proved to be inefficient (Papaikonomou, 2010).

After the collapse of Enron, the ECOFIN in April 2002 requested the EC to assess the activities of CRAs. As a result, during 2003 the EC held several discussions on the subject in the European Securities Committee (ESC) (ESME, 2008). The EC's assessment of the regulatory framework for CRAs was that legislative intervention was unnecessary. In the 2006 Communication, the EC's stance was that one of the central principles of "Better Regulation" was that legislative solutions should be applied only where they are strictly necessary for the achievement of public policy objectives and the case for new legislation in this area remained unproven (EC, 2006).

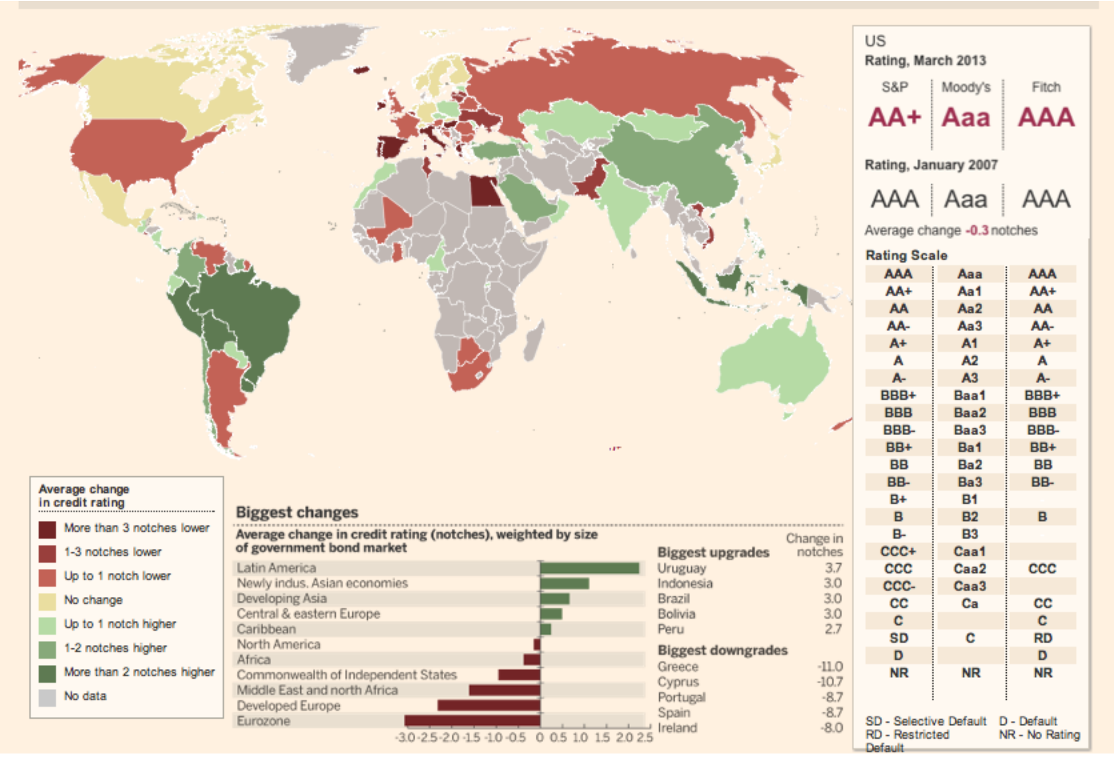
4.2.3 The Collapse of Lehman Brothers

Lannoo observes that a collapse of Lehman Brothers in 2008 was not the first sign that CRA industry was to be regulated. CRAs were in primary niches as policy victims of the financial crisis. A consultative document was circulated by the EC in six months, which institutes a single license for CRAs in the EU, subject to the supervision of the newly created ESMA (Lannoo, 2011).

After the collapse of Lehman Brothers, both the US Treasury and the EC made central clearing and exchange trading of standardized over-the-counter (OTC) derivatives mandatory. This principle was also affirmed at the international level by the G20 leaders at the Pittsburgh Summit in November 2009 (G20, 2009).

Since the collapse of Lehman Brothers, the European Central Bank has made it easier to borrow its liquidity against assets with lower credit ratings. The figure below shows the effect the financial crisis had on the world's creditworthiness (Atkins, 2013b).

The Effect the Financial Crisis had on the World's Creditworthiness (Figure 6)



Atkins, Ralph; Fray, Keith *"Dearth of triple A alters investment map."* Financial Times, 26 Mar. 2013, 29 Mar. 2013b <http://www.ft.com/intl/cms/s/0/63ae193c-9628-11e2-9ab2-00144feabdc0.html#axzz2OgunTUqP>.

As the figure above together with the Appendix (2) *A complete Ranking of the Changes in Credit Ratings Since 2007* demonstrate – a lack of triple A rated government bonds could create shortages in assets used as a collateral when borrowing funds. John Beck says global investors should ask whether triple B rated bonds are really still emerging markets in the sense they were 10-15 years ago (Atkins, 2013b). Upgrades of emerging market economies have expanded the pool of government assets rated in the BBB range. Now BBB range includes a few fallen European economies. Emerging markets were once high risk and high return assets. Now they are mainstream. A further shrinkage in the pool of AAA ratings could foreshadow a shortage of assets that can be used as security when borrowing in capital markets or from central banks (Atkins, 2013c).

4.2.4 Moral Hazard – Information asymmetry

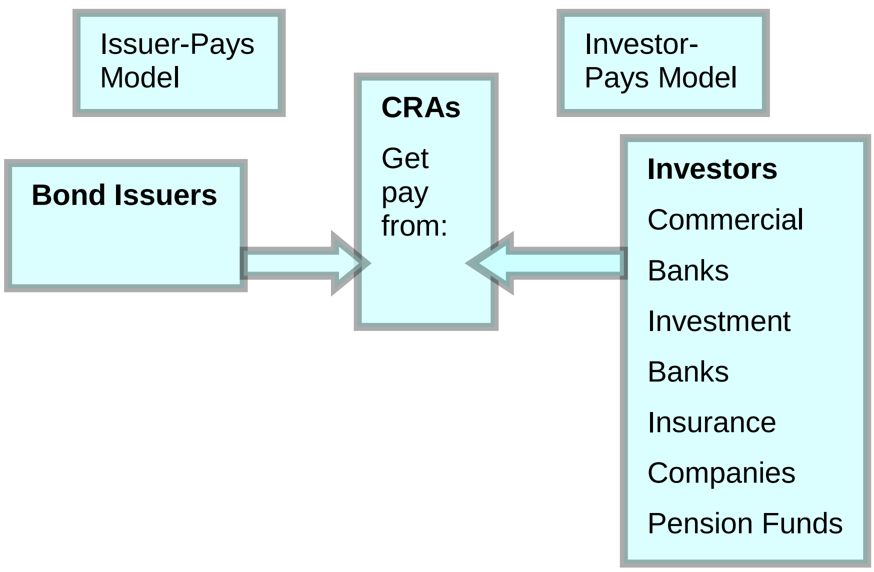
Frank Partnoy argues that information asymmetry between debt issuers and investors is one of the major reasons for CRAs existence. The asymmetry takes place when sellers have superior information to buyers about product quality and simultaneously cannot convey this information to buyers. Prices in a market with information asymmetry reflect the average quality of a product, and sellers with superior products, bearing the cost of the information asymmetry, wish to disclose the superior nature of their product for charging the highest price (Partnoy, 1999).

Moral hazard problem arises when sellers exaggerate their credibility and provide buyers with false information. CRAs are supposed to serve as a third-party information intermediary between debt issuers and investors, helping the market to determine the appropriate price. By "specializing in the gathering, analysis, examination, and dissemination" of information regarding the creditworthiness of an issuer or instrument, CRAs "eliminate the duplicative and inefficient efforts of individuals engaging in such activities" (Partnoy, 1999). However, hot markets and large profits increase the benefits of inaccurate, hastily determined ratings (Dennis, 2009), thus enabling CRAs abusing their power.

4.2.5 Issuer-Pays and Investor-Pays Business Models

Figure below illustrates Issuer-Pays and Investor-Pays Business Models.

Issuer-Pays and Investor-Pays Business Models **(Figure 7)**



The majority of CRAs nowadays use issuer-pays model to generate revenue, where issuer finances the ratings. Only a few small CRAs use investor-pays model, as it used to be in the rise of CRA Era (Langohr, 2008).[4]

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[4] See section 4.2.6 on Issuer-Pays Model problems (Conflict of Interest).

4.2.6 Conflict of Interest and Free-Rider Problem

The researcher had contacted former Senior President of Moody's William Harrington to hear an expert opinion:

> … Conflict of interest permeates all levels of levels of employment from entry-level analyst to the chairman and chief executive officer of Moody's corporation (Harrington, 2013).

Conflicts of interest are broadly associated with the "issuer pays" model in CRA industry, whereby both issuers and CRAs have an economic interest in ensuring the success of the issue: the issuer, in ensuring the sale of its securities; and the CRA – because of scale of fees at stake. Thus, ratings became almost a matter of negotiation. Conflict of interest problems were worsened by issuers' willingness to "ratings shop" so as to choose which rating to use based on the preliminary rating provided by the agency's ratings committee (McVea, 2010).

The approach of the EU CRA Regulation to the handling of conflicts of interest is set out in Annex 1: A CRA shall identify, eliminate or manage and disclose, clearly and prominently, any actual or potential conflicts of interest. The Regulation considers that the conflict arising from the payments received from rated entities or subscribers should not be prohibited; but imposes the measures to address the conflict. For example, it is prohibited to buy or sell securities of the rated Issuer (Garcia, 2012).

While the Subscriber-Pays model may help to mitigate conflict of interest problem of Issuer-Pays model, it creates a free-rider problem, as the Subscriber-Pays model relies heavily on the ability to enforce property rights to information. Technological developments are so advanced, that it is a piece of cake to transmit the information to millions of other users, who did pay for it (Garcia, 2012). In the long menu of possible causes of the credit crisis from which historians will choose, the Issuer-Pays model of the credit rating agencies will surely remain a favourite (Foley, 2013).

4.2.7 Issuer Pays Model versus Unsolicited Ratings

While unsolicited ratings may help to mitigate conflict of interest problem – often related to issuer-pays model, Papaikonomou observes: not only did the EU regulation omit to tackle the issuer-pays problem, it in fact reaffirmed it. The EU adopted a very questionable provision in the annex, whereby

> the credit rating agency is obliged to inform the rated entity at least 12 hours before publication of the credit rating and of the principal grounds on which the rating is based in order to give the entity an opportunity to draw attention of the credit rating agency to any factual errors.

This means that CRAs would now also be obliged to contact issuers who did not pay for their ratings. This provision obviously raises concerns about market abuse (Papaikonomou, 2010).

4.2.8 Transparency and Disclosure

The lack of adequate information about the characteristics and limitations of the ratings is one of the main problems (Garcia, 2012). Financial Times had published an article, where it said the three big CRAs must improve their transparency and IT and internal controls – the first ESMA inspections of Standard & Poor's, Moody's and Fitch have found (Brooke, 2012).

4.3 The First Initiative to Regulate CRAs in the EU

The first initiative to regulate CRAs in the EU was European Parliament's Resolution adopted in February 2004, which asserted the positive role of CRAs but also emphasized problems that warranted further action to ensure the CRAs performed responsibly. *Annex to the Call to CESR for Technical Advice on Possible Measures Concerning Credit Rating Agencies* summarises main features of the European Parliament resolution (EC, 2004**a**):

> • Calls upon the Commission to undertake all necessary steps, including in particular a cost-benefit analysis of the effects on European capital markets, to assess the establishment of a competent European Registration Scheme under the auspices of the Committee of European Securities Regulators (CESR) for the registration of rating agencies in Europe…
> • Calls on the Commission to submit, by 31 July 2005, its assessment of the need for appropriate legislative proposals to deal with the issues in the Parliament's Resolution and to ensure that any provisions adopted are consistent with the review of capital requirements for banks and investment firms (Basel II) (EC, 2004**a**).

As shown above, the Resolution included the regulatory discussions on CRAs over the past years and overviewed possible registration regime for CRAs in the EU, requesting the EC to submit by 31 July 2005 its assessment of the need for appropriate legislative proposals (EC, 2004**a**).

The turning point for EU to take CRA regulations under serious considerations was the international consensus on a need to regulate CRAs', reached by the G-20 leaders at the April 2009 summit (Garcia, 2012). In general terms CRAs were not regulated in Europe until 2011, when the European Union began requiring them to register with ESMA (Brooke, 2012).

4.4 European Commission's Communication

In order to prepare its report to the European Parliament, the European Commission (EC) requested ESMA (CESR) to provide *Technical Advice on Possible Measures concerning Credit Rating Agencies* to the EC published in March 2005.

> 99. In terms of policy issues concerning CRAs methodologies, regulation could concern the content of methodologies and procedures and/or could establish conditions for an adequate disclosure to the public of these aspects. Moreover, the same issues could be addressed by self-regulation.
>
> OPTION C: REGISTRATION/RECOGNITION REGIMES "STRONG" AND "LIGHT" 214. "This option could involve:
> - a recognition that a CRA complies with a pre-determined set of criteria established and published by EU authorities, without actually implying an authorisation to operate. Compliance with said criteria could be assessed by the party in charge of the recognition or implemented by a rather declarative procedure by CRAs. In this context recognition would not be a legal requirement for CRAs operating in the EU market for the provision of ratings. Rather, applying for recognition would be voluntary (CESR 2005).

In extracts above of CESR*'s* technical advice to the EC, published in March 2005, ESMA (CESR) proposed not regulating CRAs at the European level but for the time being adopting a system of self-regulation, with a monitoring of the degree to which CRAs applied the voluntary rules set out in the IOSCO Code (CESR, 2005).

The EC did not present new proposals on CRAs, relying on existing financial services directives to provide guidance to all CRA related issues. Although, in 2006 the EC published *Communication from the Commission on Credit Rating Agencies* that concluded that Market Abuse Directive and the Capital Requirements Directive amongst others combined with self-regulation by the CRAs using the IOSCO Code as fundamentals would be efficient enough to address the issues of CRAs (EC, 2006).

> 3. RELEVANT REGULATION
> …While the Directives are legally binding, the Code works on a 'comply or explain' basis – i.e. credit rating agencies are expected to incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct. Where they choose not to do this, they must explain how their Code nevertheless gives effect

> to the provisions of the IOSCO Code…
> There are three FSAP Directives, which are relevant to credit rating agencies. the Market Abuse Directive ('MAD'), which – together with its implementing Regulation and Directives – tackles the issue of insider dealing and market manipulation (market abuse)…
> The second item … is the Capital Requirements Directive ('CRD'), which introduces a new capital requirements framework for banks and investment firms. The CRD is based on the new international capital requirements framework agreed by the Basel Committee on Banking Supervision ('Basel II') in 2004 (EC, 2006).

As the Official Journal of the EU extract above discloses, the EC found necessary to put forward legislative action, if there were great differences between EU rules and IOSCO code (EC, 2006).

4.5 ESMA's Documents on CRAs

After the EC's communication, ESMA (CESR) established a voluntary framework by which CRAs willing to join needed to inform ESMA (CESR) on yearly basis on their conformity with IOSCO Code. Fitch, Moody's, S&P and Dominion Bond Rating Service (DBRS) decided to adjoin ESMA's (CESR's) proposal.

In December 2006 ESMA (CESR) published its first report to the EC *on the Compliance of Credit Rating Agencies with the IOSCO Code.*

> 29. …CESR has found CRAs codes to deviate from the IOSCO, Code which are those related with the disclosure of methodologies, unsolicited ratings and conflicts of interests.
> 41. There are two areas where the CRAs do not comply with the IOSCO Code…
> 42. Ancillary services and the requirement for operational and legal separation of credit rating business and CRA analysts from any other businesses of the CRA that may present a conflict of interest as stated in provision 2.5 of the IOSCO Code. 46. The IOSCO Code does not literally define what unsolicited ratings are…(CESR, 2006).

As shown above, the fragment of the report disclosed that agencies and IOSCO Code possessed extensively similar thinking. As of their differences, CRAs did not fully match with the IOSCO Code in areas of unsolicited ratings and ancillary services (CESR, 2006). Ancillary services are not part of the credit rating activities: they comprise market forecasts, estimates of economic trends, pricing analysis, and other general data analysis, as well as related distribution services (Garcia, 2012).

In May 2007, the EC requested of ESMA a second report specifically asking whether the recent events in financial markets made it advisable to modify the decision taken in 2006 not to regulate CRAs. In an attempt to prevent regulation enforcement, a group of CRAs began working together in October 2007 on initiatives to enhance confidence in the credit rating process (Garcia, 2012).

In May 2008 ESMA (CESR) published *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* to the EC (CESR, 2008). As shown in the table below, ESMA's (CESR's) writing reflected parallel thinking with the upcoming *Report to the European Commission on the Role of Credit Rating Agencies* of the ESME, published in June 2008 (ESME, 2008).

The Role of CRAs by ESME and CESR Reported to the EC Compared (Table 2)

***Report to the European Commission on the Role of Credit Rating Agencies* of the European Securities Markets Expert Group (ESME).**	***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 (CESR).***
• That **an enhanced self-regulatory model**, **as recommended hereunder, is made to work and is seen in the market to be effective.** • That the existing CRAs facilitate in a substantive and constructive way the reduction in the barriers to entry thereby facilitating the establishment of new CRAs (ESME, 2008).	230. … Market participants were very much in accordance with CESR's assessment of the benefits and costs of the current self-regulatory framework… 240. …Therefore **the current self-regulatory regime should be maintained possibly making the current informal CESR monitoring more effective or putting in place a monitoring function at IOSCO level.** 245. This could be brought about by a special committee or body consisting of representatives from supervisory authorities, CRAs and market participants, with the task of monitoring compliance with the IOSCO Code –including if necessary sanctioning transgressions- and possibly arbitrate cases of disagreements between **market participants or supervisors and CRAs** over the interpretation of the IOSCO Code. In order to achieve consistency across all major markets its composition should be agreed with the SEC and supervisors in other countries. Some respondents thought this role could be played by IOSCO (CESR, 2008).

Table above discloses a passage of ESMA's (CESR's) report, which conveys a proposition of maintaining the self-regulatory system by establishing an international body represented by supervisory authorities, CRAs and market participants. Those would monitor compliance with the IOSCO Code. In order to achieve consistency across all markets its rules should be agreed with the SEC and other countries bodies (CESR, ESMA, 2008).

In March 2009 following the request of the EC ESMA (CESR) published its third report on *Compliance of EU based Credit Rating Agencies with the 2008 IOSCO Code of Conduct.* This report provided further analysis of the progress made by EU-based CRAs towards implementing the updated IOSCO Code (CESR, 2009).

> 4. CESR's overall conclusion with respect to the codes of conduct of the larger, global CRAs (S&P, Moody's, Fitch, DBRS and AM Best) is that they are broadly compliant with the IOSCO Code.
> 6. With respect to the other EU CRAs, CESR – about a third have not adopted any code of conduct and strongly recommends that these CRAs consider implementing the IOSCO Code …
> 7. CESR also identifies that the large majority of the CRAs which have adopted and published codes of conduct have not adopted the 2008 amendments to the IOSCO Code.
> 8. Overall, CESR concludes that the EU CRAs that have adopted and published codes of conduct are broadly compliant with the 2004 IOSCO Code (CESR, 2009).

ESMA's overall conclusion with respect to the codes of conduct of the global CRAs (S&P, Moody's, Fitch, DBRS, and AM Best) was that they were broadly compliant with the IOSCO Code (CESR, 2009).

With respect to the other 19 EU CRAs analysed, ESMA (CESR) identified that about a third had not adopted any code of conduct and, among those that had adopted and published codes the large majority were broadly compliant with the 2004 IOSCO Code but had not adopted the 2008 amendments to the IOSCO Code (CESR, 2009).

4.6 European Commission's Regulation Proposal

On the basis of the IOSCO's international standards of 2004 key market participants in securities favoured self-regulation. European governments considered establishing a more efficient supervision of CRAs. The EC decided to propose the introduction of legislation on CRAs in the EU (Garcia, 2012).

On 8 July 2008, EU finance ministers agreed in relation to CRAs on

> the principle of European regulations guaranteeing supervision of these agencies in the EU through registration. The Council asked the Commission to present it with specific proposals for implementing a European mechanism for registering credit rating agencies (Garcia, 2012).

Consequently, on 31 July 2008, the EC published *Consultation document on a proposal for a Directive/ Regulation of the European Parliament and of the Council on CRAs,* proposing the adoption of a set of rules introducing substantive requirements for CRAs to respect to operate in the EU. The document included: authorization, supervision, and enforcement provisions, proposing two options for the EU: to reinforce ESMA's role in order to enhance cooperation between national regulators or to establish a European agency (either ESMA or a new agency) for the EU-wide registration of CRAs (EC, 2008a).

It was a priority to enforce legislation before the deadline agreed at G-20 level. A tight timetable was set to allow the EU Council and the EU Parliament to agree on the rules before the Parliament's elections in June 2009. The EC published its formal *proposal for a Regulation of the European Parliament and of the Council on CRAs* on 12 November 2008, accompanied by the proposal with four policy options (EC, 2008b):

1. Self-regulation based on the IOSCO Code, on an industry 'white paper' or on initiatives by individual CRAs.
2. A voluntary European code of conduct for CRAs developed by the industry based on the 'comply or explain* principle, together with a monitoring body that would check compliance with the code.
3. A Commission's Recommendation setting standards that CRAs would have to comply with to operate in the EU but without an enforcement mechanism.
4. EU legislation introducing a registration procedure and substantive requirements (EC, 2008b).

The EC's conclusion was that legislation was the best alternative. On 17 November 2009 the Regulation was published in the Official Journal of the EU (EC, 2009).

4.7 CRA Supervisory Structure in the EU

4.7.1 Colleges of Supervisors

There were three options for supervision (from lesser to greater degree of harmonization) by:

1. Home Member State.
2. Several countries (through colleges of supervisors) coordinated by ESMA.
3. *A possibility of* the European agency.

A compromise was a mixed system: supervision and registration decisions had to be discussed by several institutions (college of supervisors and ESMA) prior to their adoption by the competent authority of the home Member State. The EU Regulation, which set up a system of colleges of supervisors, was approved in November 2009. The main harmonizing force was the European Parliament, which at that time was unable to launch a European agency for the CRAs supervision. However, a clause of labelling the Regulation model as *temporary* was included, according to the Report of the High-Level Group on Financial Supervision in the EU by De Larosière Group (De Larosière Group, 2009).

4.7.2 The Operation of Colleges

Colleges set up by European supervisors were in charge of the registration and supervision of EU CRAs from June 2010 until July 2011. The colleges handled the applications for registration from European CRAs when the CRA Regulation became effective. Among those applicants were the EU subsidiaries of the major international CRAs. The European CRAs had to register with ESMA (formerly CESR) by 7 September 2010 (CESR, 2010). A total of 45 legal entities registered in the EU within the set date. EU competent authorities formed six colleges of supervisors and were obliged to coordinate with each other (CESR, 2010).

The decision to register an agency required unanimity of members of the college. In the event of disagreement the Regulation provided an appeal process to ESMA (CESR). Otherwise, ESMA (CESR) resolved all the other issues. In June 2010 ESMA (CESR) published a more extended guidance on registration (CESR, 2010).

In its report published in December 2010, ESMA (CESR) included a first assessment of the functioning of the colleges of competent authorities, concluding that

> The operation of these frameworks has revealed some difficulties mainly linked to the problem of ensuring consistency… (CESR, 2010).

The CRA Regulation posed a challenge for national authorities that had to set up registration and supervision of CRAs in a very short time frame, especially given that already in July 2011 ESMA took over all supervisory activities over CRAs (CESR, 2010).

4.8 ESMA Regulation Competencies

On 1 January 2011 the new European System of Financial Supervisors (ESFS) was established to unify the members of financial supervision at a national and the EU level. The ESFS is composed of the supervisory authorities of the Member States and four new bodies: ESMA, EBA, EIOPA, and ESRB[5] (ESMA, 2013**b**).

4.8.1 Registration and Supervision of CRAs

The amendment to the CRA Regulation adopted in 1st July 2011 (CRA Regulation II), conferred on ESMA all registration and supervision duties. The powers previously granted to the competent authorities of the Member States were terminated on that date. ESMA was given the authority to:

- Get an access all necessary information on CRAs.
- Examine any procedures and data including telephone calls.
- Interview or summon and hear a person.
- Carry out on-site inspections at the premises of CRAs.

In the case of an breaches committed by a CRA, ESMA is empowered to:

- Require the CRA to bring the breach to an end.
- Suspend the use of ratings for regulatory purposes.
- Temporarily prohibit the CRAs from issuing ratings.
- Withdraw the registration.
- Impose a fine or a periodic penalty payment (Garcia, 2012).

4.8.2 Fees on CRAs

According to Article 19 of the CRA Regulation, ESMA shall charge fees, which cover the costs of registration and supervision of CRAs. Article 19 requires the EC to adopt a regulation on fees following two principles: the fees collected shall fully cover ESMA's expenditure necessary for its supervisory activities; and the amount of the fees charged to individual CRAs shall be proportionate to the turnover of the CRA concerned. In May 2011, ESMA published its *Technical Advice to the Commission on Fees for CRAs* referred to in Article 19. Following fees are issued:

- Registration.

[5] See Literature review, Section 2.5 *European Supervisory Framework* for more information.

- Certification.
- Two supervisory fees:
  - On-going supervision of registered CRAs.
  - Supervision of certified CRAs (ESMA, 2011).

Registration fees per complexity of the application and size of the applicant are demonstrated below.

Registration Fees per Complexity and Size of the Applicant (Table 3)

	CRAs not issuing ratings for structured finance instruments, with no branches neither plans to endorse ratings	**CRAs which meet one of the following criteria: issuing ratings for structured finance instruments or having branches or planning to endorse ratings**	**CRAs which meet at least two of the three following criteria: the CRA has established branches, issues structured finance ratings and plans to endorse ratings**
Less than x employees	Not yet calculated (the exact amount should be close to the low in the range of 2,000 – 30,000 euros)	Not yet calculated (the exact amount should be close to the low in the range of 10,000 – 100,000 euros)	Not yet calculated (the exact amount should be close to the low in the range of 30,000 – 150,000 euros)
Between x and y employees	Not yet calculated (the amount should be established within the range of 2,000 – 30,000 euros)	Not yet calculated (the amount should be established within the range of 10,000 – 100,000 euros)	Not yet calculated (the amount should be established within the range of 30,000 – 150,000 euros)
More than y employees	Not yet calculated (the exact amount should be in close to the high in the range of 2,000 – 30,000 euros)	Not yet calculated (the exact amount should be in close to the high in the range of 10,000 – 100,000 euros)	Not yet calculated (the exact amount should be in close to the high in the range of 30,000 – 150,000 euros)

ESMA, *"ESMA's Technical Advice to the Commission on Fees for CRAs."* May 2011, <http://www.esma.europa.eu/system/files/2011_144.pdf>.

4.8.3 Cooperation and Exchange of Information

Article 26 of the CRA Regulation insists on cooperation with a straightforward mandate:

> ESMA, EBA, EIOPA, the competent authorities and the sectorial competent authorities shall cooperate where it is necessary for the purposes of this Regulation and for those of the relevant sectorial legislation (EC, 2011).

According to Article 32.2, all the information under the Regulation is confidential. However, it will not be considered confidential information if the authority or body concerned

> states at the time of communication that such information may be disclosed or where such disclosure is necessary for legal proceedings (EC, 2009).

The Regulation allows ESMA to communicate the information, if relevant for the performance of their tasks, to a limited number of authorities or bodies:

> the central banks, the European System of Central Banks and the ECB, in their capacity as monetary authorities, the ESRB and, where appropriate, to other public authorities responsible for overseeing payment and settlement systems. (EC, 2009)

The Regulation expects such authorities to communicate to ESMA information that it may need to carry out its duties under the Regulation.

4.8.4 Delegation of tasks

Possible tasks that may be delegated include the power to carry out information requests and to conduct investigations and on-site inspections. However, Article 30.4 sets some limits on delegation: main

> supervisory responsibilities according to this Regulation, including registration decisions, final assessments and follow-up decisions concerning infringements, shall not be delegated (EC, 2011).

4.8.5 Notifications and Suspension Requests

The Regulation envisages the possibility and obligation for competent authorities to inform ESMA of breaches. The requests of competent authorities to suspend the use of the ratings for regulatory purposes of the CRAs concerned are handled based on the information provided, and if ESMA considers that the request is justified, “it shall take the appropriate measures to resolve the issue”. However, where according to ESMA the request is not justified, it will inform the notifying competent authority in writing, setting out the reasons for not taking supervisory actions (Garcia, 2012).

4.8.6 Cooperation with Authorities from Third Countries

According to Article 34, ESMA may conclude cooperation agreements on exchange of information with the competent authorities of third countries for the performance of their respective tasks. These agreements are possible if the information disclosed is subject to guarantees of professional secrecy. The common EU rules on data protection will apply in the situations where ESMA is to transfer personal data to a third country authority (EC, 2001).

Article 35 pronounces, that the information may be disclosed if supervisory authority gave its agreement or where such disclosure is necessary for legal proceedings

At a global level, IOSCO provides supervisors with a multilateral forum that enables them to share information regularly as to the rules and approaches they adopt in implementing the IOSCO Code of Conduct and in regulating CRAs generally.

Conclusions

This thesis analysis shows, that Europe has taken a tremendous initiative and a great effort to impose regulations and monitor CRAs in a short time frame, in order to prevent financial destabilisation. The high-pace rate that was observed in the past will continue in the future as it seems that CRAs will not jump off the regulatory agenda, at least for the next couple of years (Garcia, 2012). On the international level, G-20 and FSB are currently working on how to end mechanistic reliance on CRA ratings, to foster the development and use of market participants' own risk assessments as well as to address the transparency issue, the conflict of interests and competition issues (G-20, 2013b).

Similarly, like the blueprint calls for setting up an international non-profit CRA – INCRA to reduce concerns about conflicts of interest that are often levelled at for-profit rating agencies (Mackenzie, 2013), Europe has been considering a European CRA. However, the EC already gives an answer to this proposal: an analysis showed that setting up a CRA with public money would be costly (€300-500 million over a period of five years), could raise concerns regarding the CRA's credibility especially if a publicly funded CRA would rate the Member States, and put private CRAs at a comparative disadvantage (EC, 2013b). Thus, the European CRA is for now a subject for debates.

Nowadays, issuer-pays CRAs not only derive their revenues from issuers, they also have revenues from subscribers that pay to get more in-depth analysis that supports the ratings. However, moving to a system of revenues coming only from subscribers could potentially undermine CRAs' revenue, and thus the quality and the coverage of ratings. It is also worth noting that if issuers do not pay for the ratings they might be less willing to provide confidential information to CRAs, thereby leading to ratings of lesser quality or to reduced coverage by CRAs if the agencies consider that they do not have sufficient information to support a rating. However, the new Regulation contains a new obligation for the Commission to re-assess by 2016 the risks of conflicts of interest due to the issuer-pays remuneration model, based on a technical advice of the ESMA (EC, 2013b).

A long relationship between a CRA and an issuer could undermine the CRA's independence and in view of the "issuer pays" model lead to a conflict of interest that could affect the quality of ratings. The Regulation introduces a mandatory rotation rule forcing issuers of structured finance products with underlying re-securitised assets, who utilise "issuer pays model", to switch to a different agency every four years. Mandatory rotation would not be a requirement for the endorsement and equivalence assessment of third country CRAs. To this end the rotation rule limits the duration of a contract between a CRA and an issuer. While the Commission had proposed a broader scope, the compromise limits the rotation rule to re-securitisations. By end-2016, the Commission will report back to the EP on the effectiveness of the rotation rule with a view to extending the scope if appropriate (EC, 2013b).

One of the weaknesses of the current EU legal framework remains the over-reliance on CRAs' ratings. The already adopted measures to supervise CRAs' activities should reduce market participants' absolute faith on CRAs assessments, as has been the case in the EU sovereign debt crisis. On other issues, proposing new rules, without leaving time for assessing the impact of the existing legislation, can entail the risk of over-regulating the CRA industry. As the time progresses, ESMA will perhaps gain more experience to address the concerns relating to the CRAs' activities (Garcia, 2012).

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List of Common Abbreviations

ABCP	Asset-backed commercial papers
ABS	Asset-backed securities
AM Best	A.M. Best Company, Inc.
AMF	Autorité des Marches Financiers
BCBS	Basel Committee on Banking Supervision
CDO	Collateralized debt obligations
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEREP	Central Repository
CESR	Committee of European Securities Regulators
CGFS	Committee on the Global Financial System
CMBS	Commercial mortgage-backed securities
CRA	Credit rating agency
CRAs	Credit rating agencies
CRD	Capital Requirement Directives
DBRS	DBRS, Limited
EBA	European Banking Authority
EC	European Commission
ECA	Export credit agencies
ECAI	External Credit Assessment Institution
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities Markets Authority (previously CESR)
EU	European Union
Fitch	Fitch Rating, Ltd
FSB	Financial Stability Board (previously FSF – Financial Stability Forum)
G-20	The Group of Twenty Finance Ministers and Central Bank Governors
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MiFID	Markets in Financial Instruments Directive
Moody’s	Moody’s Investor Services, Inc.
NRSRO	Nationally Recognized Statistical Rating Organizations
RMBS	Residential mortgage-backed securities
SEC	US Securities and Exchange Commission
S&P	Standard & Poor’s Ratings Services
Standard & Poor’s	Standard & Poor's Ratings Services
USA	United States of America

A complete Ranking of the Changes in Credit Ratings Since 2007

Country	Average change in credit rating	Fitch 07	Fitch Now	Fitch Change	Snp 07	Snp Now	Snp Change	Moody's 07	Moody's Now	Moody's Change
Greece	-11,00	A	CCC	-11	A	B-	-10	A1	C	-12
Cyprus	-10,67	A+	B	-10	A	CCC+	-11	A2	Caa3	-11
Portugal	-8,67	AA	BB+	-8	AA-	BB	-8	Aa2	Ba3	-10
Spain	-8,67	AAA	BBB	-8	AAA	BBB-	-9	Aaa	Baa3	-9
Ireland	-8,00	AAA	BBB+	-7	AAA	BBB+	-7	Aaa	Ba1	-10
Iceland	-6,33	AA-	BBB	-5	A+	BBB-	-5	Aaa	Baa3	-9
Egypt	-4,67	BB+	B	-4	BB+	B-	-5	Ba1	B3	-5
Slovenia	-4,67	AA	A-	-4	AA	A-	-4	Aa2	Baa2	-6
Italy	-4,33	AA-	BBB+	-4	A+	BBB+	-3	Aa2	Baa2	-6
Hungary	-4,00	BBB+	BB+	-3	BBB+	BB	-4	A2	Ba1	-5
Latvia	-2,67	A-	BBB	-2	A-	BBB	-2	A2	Baa3	-4
Lithuania	-2,67	A	BBB	-3	A	BBB	-3	A2	Baa1	-2
Jamaica	-2,33	B+	RD	-3	B	SD	-2	B1	B3	-2
El Salvador	-2,00	BB+	BB	-1	BB+	BB-	-2	Baa3	Ba3	-3
Ukraine	-2,00	BB-	B	-2	BB-	B	-2	B1	B3	-2
Bahrain	-1,67	A-	BBB	-2	A	BBB	-3			
Barbados	-1,67				BBB+	BB+	-3	Baa2	Ba1	-2
Pakistan	-1,67				B+	B-	-2	B1	Caa1	-3
San Marino	-1,67	AA	BBB+	-5						
Tunisia	-1,67	BBB	BB+	-2	BBB	BB	-3			
Belgium	-1,33	AA+	AA	-1	AA+	AA	-1	Aa1	Aa3	-2
Vietnam	-1,33	BB-	B+	-1	BB	BB-	-1	Ba3	B2	-2
Bahamas	-1,00				A-	BBB	-2	A3	Baa1	-1
Croatia	-1,00	BBB-	BBB-	0	BBB	BB+	-2	Baa3	Ba1	-1
Fiji	-1,00				B+	B	-1	Ba2	B1	-2
Argentina	-0,67	RD	CC	0	B+	B-	-2	B3	B3	0
Belarus	-0,67				B+	B-	-2			
Bermuda	-0,67	AA+	AA	-1	AA	AA-	-1			
Botswana	-0,67				A	A-	-1	A1	A2	-1
France	-0,67	AAA	AAA	0	AAA	AA+	-1	Aaa	Aa1	-1
Mali	-0,67	B-			B	NR	-2			
New Zealand	-0,67	AA+	AA	-1	AA+	AA	-1	Aaa	Aaa	0
Romania	-0,67	BBB	BBB-	-1	BBB-	BB+	-1	Baa3	Baa3	0
Seychelles	-0,67		B		B	NR	-2			
South Africa	-0,67	BBB+	BBB	-1	BBB+	BBB	-1	Baa1	Baa1	0
Venezuela	-0,67	BB-	B+	-1	BB-	B+	-1	B2	B2	0
Austria	-0,33	AAA	AAA	0	AAA	AA+	-1	Aaa	Aaa	0
Bosnia and Herzegovina	-0,33							B2	B3	-1
Bulgaria	-0,33	BBB	BBB-	-1	BBB+	BBB	-1	Baa3	Baa2	1
Cook Islands	-0,33				BB-	B+	-1			
Ghana	-0,33	B+	B+	0	B+	B	-1			
Isle of Man	-0,33				AAA	AA+	-1			
Macedonia	-0,33	BB+	BB+	0	BB+	BB	-1			
Malta	-0,33	A	A+	1	A	BBB+	-2	A3	A3	0
Montenegro	-0,33				BB	BB-	-1			
Russia	-0,33	BBB+	BBB	-1	BBB+	BBB	-1	Baa2	Baa1	1
UK	-0,33	AAA	AAA	0	AAA	AAA	0	Aaa	Aa1	-1
US	-0,33	AAA	AAA	0	AAA	AA+	-1	Aaa	Aaa	0

Canada	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Denmark	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Finland	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Germany	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Grenada	-0,33				B-	CCC+				
Guatemala	0,33	BB+	BB+	0			-1	Ba2	Ba1	1
Japan	0,00	AA	A+	-2				A2	Aa3	2
Luxembourg	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Mexico	0,00	BBB	BBB	0				Baa1	Baa1	0
Mongolia	0,33	B+	B+	0	B+	BB-				
Netherlands	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Norway	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Slovakia	0,00	A	A+	1	A	A	0	A1	A2	-1
Sweden	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Switzerland	0,00	AAA	AAA	0	AAA	AAA	0	Aaa	Aaa	0
Australia	0,33	AA+	AAA	1	AAA	AAA	0	Aaa	Aaa	0
Cameroon	0,33	B	B	0	B-	B	1			
Czech Republic	0,33	A	A+	1				A1	A1	0
Georgia	0,33		BB-		B+	BB-	1			
Kazakhstan	0,33	BBB	BBB+	1				Baa2	Baa2	0
Kuwait	0,33	AA-	AA	1						
Mauritius	0,33							Baa2	Baa1	1
Moldova	0,33	B-						Caa1	B3	1
Nicaragua	0,33							Caa1	B3	1
Oman	0,33				A-	A	1			
Rwanda	0,33	B-	B	1						
Trinidad	0,33				A-	A	1	Baa1	Baa1	0
Azerbaijan	0,67	BB	BBB-	2		BBB-				
Costa Rica	0,67	BB	BB+	1		BB		Ba1	Baa3	1
Ecuador	0,67	B-	B-	0	CCC+	B	2	Caa1	Caa1	0
India	0,67	BBB-	BBB-	0				Ba2	Baa3	2
Poland	0,67	BBB+	A-	1	BBB+	A-	1	A2	A2	0
Dominican Rep	1,00	B	B	0	B	B+	1	B3	B1	2
Estonia	1,00	A	A+	1	A	AA-	2	A1	A1	0
Paraguay	1,00		BB-		B-	BB-	3			
Qatar	1,00				A+	AA	2	Aa3	Aa2	1
Colombia	1,33	BB	BBB-	2				Ba2	Baa3	2
Israel	1,33	A-	A	1	A-	A+	2	A2	A1	1
Lebanon	1,33	B-	B	1	B-	B	1	B3	B1	2
Philippines	1,33	BB	BB+	1				B1	Ba1	3
Saudi Arabia	1,33	A+	AA-	1	A+	AA-	1	A2	Aa3	2
Suriname	1,33	B	BB-	2	B	BB-	2			
Chile	1,67	A	A+	1	A	AA-	2	A2	Aa3	2
China	1,67	A	A+	1	A	AA-	2	A2	Aa3	2
S Korea	1,67	A+	AA-	1	A	A+	1	A3	Aa3	3
Hong Kong	2,00	AA-	AA+	2	AA	AAA	2	Aa3	Aa1	2
Turkey	2,00	BB-	BBB-	3	BB-	BB	1	Ba3	Ba1	2
Panama	2,33	BB+	BBB	2	BB	BBB	3	Ba1	Baa2	2
Peru	2,67	BB+	BBB	2	BB+	BBB	2	Ba3	Baa2	4
Bolivia	3,00	B-	BB-	3	B-	BB-	3	B3	Ba3	3
Brazil	3,00	BB	BBB	3	BB	BBB	3	Ba2	Baa2	3
Indonesia	3,00	BB-	BBB-	3	BB-	BB+	2	B1	Baa3	4
Uruguay	3,67	B+	BB+	3	B+	BBB-	4	B1	Baa3	4