Credit Rating Agencies as Gatekeepers: What Went Wrong?

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I INTRODUCTION

Hardly a day goes by without some mention of the credit crunch being made in the media.[1] Consequences are widespread – there are numerous instances of giant financial institutions that toppled or whose existence is threatened as a result of the credit crunch[2] and even countries go bankrupt.[3] The global economic slowdown that resulted is having a foreseeable detrimental impact on the ordinary lives of everyday people.[4]

In a world that is trying to make sense of the global financial crisis and looking for scapegoats, many fingers are pointing to credit rating agencies such as Moody's, Standard and Poor's and Fitch, who failed to sound the warning bell about the credit bubble. The fact that this is not the first time that they failed to warn of imminent financial collapse contributes to their current disfavour.[5]

This paper discusses the reasons for their supposed failure and examines proposed regulatory reforms to determine whether and how the effectiveness of credit rating

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[1] A search using the term 'credit crunch' on the website of *The Australian* newspaper in October 2008 alone yielded more than 2290 results.

[2] The demise of Bear Sterns and of Lehman Brothers in mid-September being some of the most sensational. The survival of the world's biggest insurance company, AIG, was subsequently seriously threatened by the bankruptcy filing of Lehman Brothers. Merril Lynch was taken over by the Bank of America on the orders of the US Federal Reserve during the same time.

[3] Iceland had to approach the International Monetary Fund for financial aid.

[4] As is indicated by newspaper headlines talking of pensioners that are struggling to make ends meet, job losses and threats of an increase in unemployment. Just some illustrative headlines in *The Australian* are: 'Couple's Lifetime Savings Dwindling Daily' (21 October 2008), 'Unemployment Rate Tipped to Hit 9pc in Two Years' (23 October 2008).

[5] Their sluggish response in regard to the debt rating of Enron and Worldcom, where these corporations were downgraded to below investment grade status shortly before their respective collapses, is well-known and often referred to. See eg John C Coffee Jr *Gatekeepers: The Professions and Corporate Governance* (2006) 285; Claire A Hill 'Rating Agencies Behaving Badly: The Case of Enron' (2002 – 2003) 35 *Connecticut Law Review* 1145, 1145; Claire A Hill 'Regulating the Rating Agencies' (2004) 82 *Washington University Law Quarterly* 43, 43.

agencies as gatekeepers could be increased. In order to do this the role of credit rating agencies will first be examined to determine what qualify them as gatekeepers, after which an overview of some of the possible causes for the perceived failure of credit rating agencies as gatekeepers will be provided.

The next part of the paper will focus on proposals for regulatory reform. This discussion will be informed by developments in the USA and Europe, which will be analysed to determine their usefulness in an Australian context. This discussion will also form the basis of the recommendations made at the end of this contribution.

II DEFINING CREDIT RATING AGENCIES AS GATEKEEPERS

The function of credit rating agencies is to 'rate' investment and credit instruments to make it easier for non-specialist investors to determine the risk inherent to particular investments. The four highest rating categories are from AAA to BBB- and are referred to as 'investment grade', while any investment instrument ranked below BBB- will be classified as 'speculative grade' or 'junk'.[6] Ratings are based on the agency's opinion as to the obligor's capacity to repay capital and interest on an instrument when due.[7] Initial ratings are monitored on a continuous basis and 'upgrading' or 'downgrading' will take place where appropriate.[8]

Credit rating agencies' continuous monitoring of a firm's ability to repay its investors could, theoretically, serve as a very valuable investor safeguard. As a consequence firms, being aware of the importance of obtaining or maintaining a good rating for their investment instruments, would in theory ensure that the necessary standards are in place to secure a good rating. In this way credit rating agencies seem to fit Kraakman's definition of a gatekeeper as a 'professional who is positioned so as to be able to prevent wrongdoing by withholding necessary cooperation or consent'.[9]

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[6] Hill, 'Regulating the Rating Agencies', above n 5, 48.
[7] Ibid.
[8] Ibid.
[9] Reinier Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2 *Journal of Law, Economics and Organisation* 53, 53.

Coffee provides a further refinement of the definition of a gatekeeper by emphasising the fact that gatekeepers typically have 'reputational capital' that can be 'pledged or placed at risk by the gatekeeper's vouching for its client's assertions or projections'.[10] This qualification of the definition indicates that gatekeepers have an important incentive to comply with their duties, namely protecting the value attached to their own reputations. Applied to rating agencies this means that it is in their own best interest to ensure the integrity of their ratings, as their ratings will not be valued otherwise.

III REASONS FOR FAILURE OF CREDIT RATING AGENCIES AS GATEKEEPERS

A Lack of Competition

Moody's and Standard & Poor's have an effective duopoly in the rating market with a market share of close to 80%.[11] This could be attributed to regulators' method of regulating entry into the credit rating market,[12] as well as to the operation of the market itself.[13] On the one hand regulators' effort to ensure the quality of rating agencies that enter the market in this way is understandable. On the other hand, the lack of competition raises the concern that credit rating agencies have little incentive to upgrade their services and that it could contribute to general laxity.[14]

One seemingly obvious way to address this problem would seem to be to open up the market for new credit rating agencies by changing the way in which entry into the market is regulated. On the surface this may appear like a good solution. However, closer inspection reveals that such a step may have a number of negative spin-offs.

Hill warns against the possible danger that issuers of debt may start shopping for favourable ratings where they have many credit rating agencies to choose from, just as

[10] Coffee, above n 5, 3.
[11] Coffee, above n 5, 284; Hill, 'Rating Agencies Behaving Badly', above n 5, 1147.
[12] Coffee, above n 5, 285; Stéphane Rousseau 'Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach' (2005-2006) 51 *McGill Law Journal* 617, 628.
[13] Hill, 'Regulating the Rating Agencies', above n 5, 54; Rousseau, above n 13, 628.
[14] Coffee, above n 5, 285; Rousseau, above n 13, 629.

they shopped for favourable accounting treatment.[15] This concern is supported by empirical evidence that suggests that Fitch, maybe in an attempt to establish a place for itself in the market, generally provides more favourable ratings than Moody's or Standard & Poor's.[16] Another negative side-effect of such a step could be that a larger number of smaller rating agencies will lack the basis that is required to make effective comparisons, which a large, reputable CRA who rates a large number of bond issues will have.[17]

Ultimately, the entry of more CRA's into the market could thus result in ratings of a poorer quality.

B Conflict of Interest

Initially CRAs generated income by way of subscriber fees paid by investors.[18] It became necessary for them to change their business model in the early 1970s to a model where issuers were being charged for rating services provided by the rating agencies.[19] The current business model gives rise to another possible cause for concern, namely the potential for a conflict of interest where the party that the credit rating agency is supposed to monitor, is paying it to do so[20] and raises questions about the independence of rating agencies when rating debt instruments of their clients.

The way in which the market for credit ratings operates would indicate that this concern is more perceived than real, however. A practice developed whereby an issuer would typically obtain the rating of both Moody's and Standard and Poor's for an issue, which means that a client cannot force the two big players to compete against each other.[21] As discussed before, there is furthermore very little competition in the credit rating market, which prevents a client from taking its business elsewhere

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15 Hill, 'Regulating Rating Agencies', above n 5, 43.
16 Ibid 63.
17 Ibid 75.
18 Hill 'Regulating the Rating Agencies', above n 5, 50; Rousseau, above n 12, 625.
19 Rousseau, above n 12, 625.
20 Coffee, above n 5, 286; Hill 'Regulating the Rating Agencies', above n 5, 50; Jeffrey Manns 'Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability' (2008) SSRN <http://ssrn.com/abstract=1199622> at 15 December 2008, 9.
21 Coffee, above n 5, 286; Hill, 'Regulating the Rating Agencies', above n 5, 74, 91.

if not satisfied with a particular rating.[22] These factors effectively preclude a client from being able to 'pressure' the rating agencies to provide a good rating.

CRA's furthermore have thousands of clients, with individual raters within an agency not as dependent upon any individual client and not receiving incentive-based compensation[23] – CRA's are consequently not as vulnerable to 'capture' by a client as audit partners of auditing firm.[24] Rating agencies are in a real sense very dependent on their reputations[25] and it is very unlikely that they will stake this for one client or a small number of clients out of thousands.

The apparent conflict of interest that currently exists therefore does not seem to present too much of an obstacle to the effective functioning of rating agencies.[26]

It is important not to be too complacent in this regard, however, as the situation could change in future should the credit rating market become more open and competitive and should rating agencies increasingly find themselves in a position to offer ancillary services and becoming dependent on the income generated in this way.[27]

C Quality of Ratings

Rating agencies have also been criticised for not always 'getting it right' with their ratings – not as a result of bad faith, but rather because of a 'lack of street wisdom'[28]

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[22] Hill, 'Regulating the Rating Agencies', above n 5, 74.

[23] Hill, 'Regulating the Rating Agencies', above n 5, 76 also highlights the remuneration structure of credit analysts as a factor that contributes to the independence of rating agencies.

[24] Coffee, above n 5, 34, 287.

[25] Hill, 'Regulating the Rating Agencies', above n 5, 74 indicates that rating agencies 'could not function without a reputation for independence'.

[26] Rousseau, above n 12, 635, with reference to empirical studies that were conducted, notes that "[o]n the whole, it does not appear that the potential conflicts of interest to which CRAs are susceptible have materialized into any real misbehaviour on their part".

[27] Amélie Champsaur, *The Regulation of Credit Rating Agencies in the US and the EU: Recent Initiatives and Proposals* LLM paper, Harvard Law School (May 2005), 15 notes that the fact that CRAs sometimes provide ancillary services in addition to credit ratings is considered as 'the greatest potential source of conflict of interest in the CRA/issuer relationship'; also see Hill, 'Regulating the Rating Agencies', above n 5, 51, 92.

[28] Hill, 'Regulating the Rating Agencies', above n 5, 82, with reference to a contribution in *The Economist* (8 February 2003) titled 'Exclusion Zone: Regulators Promise a Belated Review of the Ratings Oligopoly'.

and commentators question the thoroughness of analyses conducted by rating agencies' analysts, as well as the training and qualification of these analysts.[29]

Shortcomings that can be identified in the rating process include, for example, the lack of transparency in the ratings process which resulted in the inability of the market to understand the bases of ratings of certain structured products.[30] Even more worrying is the fact that there are often limited or even no independent review or due diligence conducted by the CRAs to confirm whether information provided to them in connection with assets underlying structured securities were correct.[31] In some instances there are even indications that CRAs relied on information provided to them that may have been questionable or suspect at first glance, considering market changes at the time.[32]

In light of Coffee's definition of gatekeepers as bodies who highly value their 'reputational capital',[33] it would seem surprising that CRAs would not take more care to 'get it right' when rating. One could assume that this indicates that 'reputational capital' is not as highly valued by CRAs as other gatekeepers.[34] This could be caused by the fact that there is a lack of competition in the rating industry, along with the possibility of an artificial demand created for ratings through regulation[35] – as a result of these factors there is little incentive for rating agencies to improve their services and the general overall quality of their ratings.

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[29] Hill, 'Rating Agencies Behaving Badly', above n 5, 1145; Rousseau 631.

[30] Securities Industry and Financial Markets Association *Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Task Force* (July 2008), (hereafter SIFMA Taskforce Recommendations) 3.

[31] SIFMA Taskforce Recommendations 5; Rousseau, above n 12, 640.

[32] SIFMA Taskforce Recommendations 5.

[33] Coffee, above n 5, 4. See discussion par 2 above.

[34] Rousseau, above n 12, 639 – 640 terms reputation as a 'noisy indicator' and concludes that a loss of reputation in the case of a CRA 'may not necessarily translate into a loss of market share for an agency, thereby mitigating the impact of reputational pressures on established agencies'.

[35] Frank Partnoy, 'The Sisken and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies' (1999) 7 *Washington University Law Quarterly* 619, 651 – 653, makes the point that the value of a rating simply lies therein that it enable favourable regulatory treatment for issuers. Champsaur, above n 27, 21 agrees that the informational value of credit ratings 'does not suffice to justify the demand for credit ratings'. This view (the 'regulatory license view') is discounted by commentators such as Hill, 'Regulating the Rating Agencies', above n 5, 66 – 67 and Rousseau, supra n 12, 634.

It would also seem that CRAs are better at 'getting it right' with initial ratings, but not so good at monitoring ratings already assigned.[36] One reason for this could be the fact that it is much harder to obtain an initial rating, and that not as much information is required on an ongoing basis to maintain that rating. Some empirical evidence would also indicate that rating changes do not systematically lag the market and could still be valuable for providing new information to investors.[37]

In their defence, CRAs must further be sensitive to the effect that a downgrading of a rating would have on the market. A downgrading that takes place too early could in fact result in the demise of an institution and one would assume that they would be extremely careful of being regarded as the cause of that.

D Accountability

There would furthermore seem to be a general lack of accountability on the part of rating agencies when they do 'get it wrong'.[38] Once again there could be a number of reasons for this.

One reason could be that CRAs are only subject to the general liability regime, the application of which would prove very difficult for investors, as a result of which potential liability would not significantly affect the behaviour of rating agencies.[39]

Other reasons could be jurisdiction specific, for example, in the USA ratings are traditionally afforded the protection of the First Amendment, as their ratings are regarded as 'predictive opinions',[40] rather than statements of fact.[41] As a result they

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[36] Rousseau, supra n 12, 632 refers to the two anecdotal examples of Enron, where CRAs maintained Enron's credit rating at above investment grade until days before it filed for bankruptcy, as well as General Motors and Ford, who also maintained a credit rating of above investment grade while the market traded their bonds as equivalent to 'junk' status.

[37] Rousseau, supra n 12, 633.

[38] Rousseau, supra n 12, 643 refers to this problem as the 'accountability gap' and describes it as essentially 'an imbalance between the power of CRAs and the possibility of holding them responsible'.

[39] Ibid 642.

[40] Raymond W McDaniel, President of Moody's Investors Service, emphasised this point in his Written Statement before the United States Securities and Exchange Commission (2002) SEC <http://www.sec.gov/news/extra/credrate/moodys.htm> at 17 December 2008, par 1.

are not liable for negligent misrepresentations, but only for misrepresentations that result from reckless conduct.[42]

IV OVERVIEW OF PROPOSED REFORMS

The purpose of this overview is not to provide a detailed analysis of proposed reforms, but rather to provide enough background to determine whether reforms are indicative of particular and similar concerns in all jurisdictions, whether the reforms ultimately address the problems and also whether there is any coherence between reforms in the various jurisdictions.

A Australia

A report issued jointly by the Treasury and ASIC in October 2008[43] provides a description of the current regulatory framework, regulatory issues, international developments and market context in relation to CRAs.[44] The report identifies a number of regulatory issues, namely the appropriate level of external oversight; the quality of the ratings process; the monitoring and updating of ratings; conflicts of interest; disclosure issues; the adequacy of organisation resources; and over-reliance on credit ratings by investors.[45]

A number of changes were announced on the basis of information contained in the report.[46] The first of these is that ASIC will remove the exemption for CRAs from the

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[41] John Patrick Hunt 'Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement' (2008) SSRN <http://ssrn.com/abstract=1267625> at 17 December 2008, 5.

[42] Champsaur, above n 27, 13; Rousseau, above n 12, 642.

[43] Joint Report by the Treasury and the Australian Securities and Investments Commission *Review of Credit Rating Agencies and Research Houses* (October 2008) ASIC <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep143.pdf/$file/rep143.pdf> at 19 November 2008 (hereafter ASIC Report).

[44] ASIC Report 3.

[45] ASIC Report 15.

[46] See Senator Nick Sherry, Minister of Superannuation and Corporate Law *Improved Australian Controls for Credit Rating Agencies and Research Houses* Media Release No 077 of 13 November 2008 (2008) Minister for Superannuation and Corporate Law <http://minscl.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/077.htm&pageID=&min=njs&Year=&DocType=0> at 22 December 2008.

requirement in section 911A of the *Corporations Act 2001*[47] to hold and Australian Financial Services Licence. In addition, CRAs will be required to issue an Annual Compliance Report in which they will have to indicate the extent to which they have complied with the International Organisation of Securities Commissions'[48] Code of Conduct Fundamentals for CRAs.[49]

The latter requirement could impact significantly on the operations of CRAs in Australia, due to changes made to the IOSCO Code of Conduct. These changes relate to the quality and integrity of the rating process; CRA independence and avoidance of conflicts of interest; CRA responsibilities to the investing public and issuers; and the disclosure of the Code of Conduct and communication with market participants.

Extensive changes have been made to section 1 of the IOSCO Code of Conduct to improve the quality and integrity of the rating process. These include requirements to ensure an objective decision-making process for reviewing ratings; the use of current and suitable methodologies and models in the rating process; that the quality of information used by CRAs is such that it supports a credible rating; that employees possess appropriate knowledge and experience; that adequate resources are allocated to monitoring and updating its ratings and so forth.[50]

The matter of CRA independence and avoidance of conflicts of interest is addressed in section 2 of the IOSCO Code of Conduct, which was modified to include the work of past analysts in its operation; periodic review of remuneration policies in an attempt to ensure that they do not detract from the objectivity of the rating process; to discourage 'ratings shopping'; require CRAs to define what it considers and does not consider to be ancillary business, as well as the reasons for that.[51]

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[47] *Corporations Act 2001* (Cth).
[48] Hereafter referred to as IOSCO.
[49] Technical Committee of IOSCO *Code of Conduct Fundamentals for CRAs* (Revised May 2008) International Organization of Securities Commissions <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf> at 11 December 2008 (hereafter IOSCO Code of Conduct).
[50] Ibid 14 – 15.
[51] Ibid 15 – 16.

Section 3 of the IOSCO Code of Conduct pertains to CRAs' responsibilities to the investing public and issuers. Changes made to section 3 are focussed on increased transparency and improving investor understanding of the relative value of credit ratings. CRAs are required, for example, to 'assist investors in developing a greater understanding of what a credit rating is';[52] to provide sufficient information so as to 'assist investors in drawing performance comparisons between different CRAs';[53] and to help investors 'understand the basis for the CRA's rating'.[54]

Further transparency is achieved through changes to section 4 of the IOSCO Code of Conduct, in terms of which CRAs are required to publish prominently on its website links to its code of conduct, a description of the methodologies it uses and information about its historic performance data.[55]

It is envisaged that these measures will 'improve oversight of CRAs and increase transparency and accountability of their actions' as well as 'improve the conduct of CRAs'.[56]

B United States of America

The United States Securities and Exchange Commission issued a summary report in July 2008 to publish the findings of its examinations on CRAs' activities in rating particular debt instruments,[57] specifically subprime residential mortgage-backed securities[58] and collateralized debt obligations.[59] The summary report identifies a

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[52] Ibid par 14.
[53] Ibid par 15.
[54] Ibid par 16.
[55] Ibid par 19.
[56] See Senator Nick Sherry, Minister of Superannuation and Corporate Law *Improved Australian Controls for Credit Rating Agencies and Research Houses* Media Release No 077 of 13 November 2008 (2008) Minister for Superannuation and Corporate Law <http://minscl.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/077.htm&pageID=&min=njs&Year=&DocType=0> at 22 December 2008, Attachment: Treasury Discussion of Progress against FSF Recommendations on Credit Rating Agencies.
[57] Staff of the Securities and Exchange Commission *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (8 July 2008) SEC <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (hereafter SEC Summary Report).
[58] Hereafter RMBS.

number of issues in relation to the practices of rating agencies surrounding the rating of RMBS and CDOs and also provides a general summary of remedial actions.

Issues identified include that CRAs seem to have struggled to cope with the growth in number and complexity of RMBS and CDOs; the non-disclosure of important aspects of the rating process in some instances; inadequate documentation of policies and procedures for rating the instruments mentioned; failure to document significant steps in the ratings process, such as a rationale for deviation from models normally used; processes used to monitor ratings is 'less robust' that the processes used for initial ratings; improvement of management of conflicts of interest; and the fact that internal audit processes varied substantially from among CRAs.[60]

The SEC proposed a number of new rules with a view to 'increase transparency in the ratings process' and to 'curb practices that contributed to recent turmoil in the credit market'.[61] Many of these rules are indeed aimed at increasing transparency in the ratings process, for example by requiring NRSROs[62] to make all of their ratings and subsequent rating actions publicly available; to publish performance statistics for one, three and ten years within each rating category to facilitate comparison with their competitors in the industry; to disclose how frequently credit ratings are reviewed and so forth.[63]

Another key purpose of the rules would seem to improve efficacy of conflict of interest procedures, as illustrated by rules in terms of which NRSROs are prohibited from issuing a rating where the NRSRO or person associated with it has made recommendations as to structuring the same products that it rates; those who rate issuers are prohibited from receiving gifts from those who receive ratings in an amount exceeding $25; and that anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it, to name a few.[64]

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[59] Hereafter CDOs.
[60] SEC Summary Report 1 – 2.
[61] Ibid 4.
[62] Or Nationally Recognised Statistical Rating Organisations – a designation conferred by the SEC through a registration process.
[63] SEC Summary Report 4 – 5.
[64] Ibid 4 – 5.

A further aspect addressed by the rules is increasing the quality of ratings. An NRSRO is, for example, prohibited from issuing a rating on a structured product unless information on the characteristics of assets underlying the product is available.[65]

C European Union

Proposed reforms in the European Union go significantly further than what is proposed in most other jurisdictions. It came about as a result of an investigation initiated by the European Commissioner for Internal Market and Services, Charlie McCreevy, who approached the Committee of European Securities Regulators[66] and the European Securities Market Expert Group[67] for advice.

The CESR advocates a self-regulatory approach, stating that

> there is no evidence that regulation of the credit rating industry would have had an affect on the issues which emerged with ratings of US subprime backed securities and hence continues to support market driven improvement.[68]

The CESR further proposes the IOSCO Code to be the minimum standard on which CRA conduct of business should be assessed.[69] Compliance with these standards will be ensured through the establishment of an international CRAs standard setting and monitoring body to 'develop and monitor compliance with international standards in line with the steps taken by IOSCO'.[70] This body will operate on a transparent basis and use a 'name and shame' mechanism to enforce compliance.[71]

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[65] Ibid 4.
[66] Hereafter CESR.
[67] Hereafter ESME. ESME is an advisory body to the European Commission composed of securities markets practitioners and experts that was set up in April 2006.
[68] The Committee of European Securities Regulators *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* (ref CESR/08-277) (May 2008) CESR, <http://www.cesr-eu.org/popup2.php?id=5049>, 3 (hereafter CESR Report).
[69] Ibid.
[70] Ibid.
[71] Ibid.

ESME also indicates preference for a system of self-regulation for CRAs, stating that '[t]here is not regulatory panacea in isolation'[72] and that 'full formal regulation may be counter-productive'.[73] This conclusion is subject to two qualifications, however, namely that an enhanced self regulatory model 'is made to work and is seen in the market to be effective'[74] and that existing CRAs 'facilitate in a substantive and constructive way the reduction in the barriers to entry thereby facilitating the establishment of new CRAs'.[75]

McCreevy has little faith in the IOSCO Code[76] and it is probably not too much of a surprise that he opted for a regulatory solution. This solution is embodied in a 'Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies'.[77]

The Explanatory Memorandum to the proposed regulations suggests that adaptation costs will be limited, as substantive provisions are inspired by the IOSCO Code with which many CRAs already comply on a voluntary basis.[78] However, the legislative proposal contains significant changes to the current system.

The first obvious difference is the departure from a system of self-regulation, the reason for which is explained as follows in the Explanatory Memorandum:

> Self-regulation based on voluntary compliance with the IOSCO code does not appear to offer an adequate, reliable solution to the structural deficiencies of the business…the Commission considers the revised IOSCO code of conduct to be the

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[72] European Securities Markets Expert Group *Report to the European Commission: Role of Credit Rating Agencies* (June 2008) ESME <http://ec.europa.eu/internal_market/securities/docs/esme/report_040608_en.pdf> at 21 October 2008, 22 (hereafter referred to as ESME Report).
[73] Ibid.
[74] Ibid.
[75] Ibid.
[76] Eg, in the *Irish Times* (Ireland) 16 June 2008 it is reported that he regards the IOSCO Code as a 'toothless wonder' <http://www.irishtimes.com/newspaper/finance/2008/0616/1213369964926_pf.html> at 21 October 2008 and that 'no supervisor appears to have got as much as a sniff of the rot at the heart of the structured finance rating process before it all blew up'. In a press conference announcing the legislative proposal in regard to credit rating agencies (12 November 2008) <http://www.cesr-eu.org/popup2.php?id=5050> at 21 January 2009 he refers to the revised format of the code once again as a 'toothless tiger'.
[77] < http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf>.
[78] Explanatory Memorandum par 2.2.

> global benchmark. However, the code has some limitations…Most importantly, the code provides no enforcement mechanism but only invites credit rating agencies to give reasons if they do not comply with it (the 'comply or explain' approach.[79]

Under the proposals CRAs will be required to register in the EU to 'ensure that its credit ratings can be used for regulatory purposes'.[80] This registration can be withdrawn under particular circumstances, for example where the CRA no longer meets the conditions under which it was registered,[81] or where it has infringed the provisions of the regulation governing the operating conditions for credit rating agencies.[82] CRAs will thus have to be 'authorised and operate in full conformity with EU rules' and will be 'supervised by EU supervisors'.[83]

'Supervisory measures' that Member States can implement to ensure compliance with the proposals are, for example to withdraw the CRAs registration,[84] to impose temporary prohibition of issuing credit ratings,[85] to impose suspension of the use of credit ratings,[86] to adopt appropriate measures to ensure that credit rating agencies continue to comply with legal requirements,[87] to issue public notices when a credit rating agency breaches the obligations set out in the proposals,[88] and even to refer matters for criminal prosecution to the competent jurisdictions.[89]

Provision is also made for penalties to be levied by Member States in case of infringement of the proposed provisions and will at a minimum cover cases of gross professional conduct and lack of due diligence.[90] Member States are required to provide for penalties that are 'effective, proportionate and dissuasive'.[91]

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[79] Explanatory Memorandum par 1.1.
[80] Art 12(1).
[81] Art 17(1)(c).
[82] Art 17(1)(d).
[83] McCreevy Press release, above n 77.
[84] Art 21(1)(a).
[85] Art 21(1)(b).
[86] Art 21(1)(c).
[87] Art 21(1)(d).
[88] Art 21(1)(e).
[89] Art 21(1)(f).
[90] Art 31.
[91] Art 31.

Annex I furthermore contains a number of strong corporate governance rules aimed at improving independence and avoidance of conflicts of interest. These include a requirement that CRAs to have an internal function to review the quality of their ratings. For this purpose they should have at least three independent directors on the board whose remuneration is not linked to the business performance of the CRA. The independent directors can be appointed for a single term not exceeding five years only and can only be dismissed in case of misconduct or professional underperformance. Independent directors will specifically be tasked with 'monitoring the development of the credit rating policy, the effectiveness of the internal quality control system of the credit rating agency on the credit rating process to ensure that there are no conflicts of interest and the compliance and governance processes including the efficiency of the review function'.[92]

In terms of the proposal credit rating agencies are prohibited from consultancy or advisory services to the rated entity, and may provide ancillary services to the extent that it does not present conflicts of interest with its credit rating activity.[93]

The extensive requirements pertaining to the quality of credit ratings are furthermore interpreted to indicate that CRAs will no longer be able to use the defence that their credit ratings are just opinions.[94]

D Summary

Proposed changes in the three jurisdictions seem to focus on the same key aspects in a bid to improve the performance of credit rating agencies: improving the quality of ratings; improving the investing public's understanding of the purpose and relative value of credit ratings; improving transparency with regard to the rating process; and implementing measures to ensure that there are no conflicts of interest.[95]

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[92] Annex I, Section A, par 2.

[93] Annex I, Section B, par 4. The credit rating agency can determine what it regards as ancillary services.

[94] McCreevy Press release, above n 77.

[95] Interestingly enough, none of the jurisdictions referred to in this contribution seems to actively propose getting rid of the issuer-pays system which could be regarded as a key-contributor to concerns about conflicts of interest.

The main difference in the proposals seems to lie in the way in which compliance with these new measures is envisaged. On the one hand there is a view that CRAs should be allowed to self-regulate, while the opposite view is that this will be ineffective and that compliance should be enforced through sanctions and penalties.

A view in favour of self-regulation is probably based on a 'reputational capital' approach in terms of which CRA's value their reputations to such an extent that they will ensure high quality ratings to maintain good reputations. It is envisaged that accountability will be ensured by the adoption of standard codes of conduct[96] on a 'comply or explain' basis. This seems to be the approach favoured in Australia and the United States of America.[97]

Others are sceptical of this method[98] and advocates a different approach, such as 'disclose-or-disgorge', specifically in relation to new products.[99] The European Union went even further in its proposals for reform and is in favour of enforcement by way of sanctions and penalties.

V CONCLUSION

One cannot deny that rating agencies are very powerful players in the free market[100] and also very important players.[101] Nor can one deny the importance of their role in

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[96] Eg the IOSCO Code.

[97] A number of academics are in favour of this approach. See eg Rousseau, above n 12, 664

[98] See eg Hunt, 'Credit Rating Agencies and the "Worldwide Credit Crisis", above n 41, 74 who is specifically concerned about the rating of novel products and warns that

> [f]ear of losing reputational capital is not likely to constrain credit rating agencies from issuing low-quality ratings on novel products, principally because they have no reputation in this type of product ratings to lose.

[99] Ibid 72 – 74.

[100] In an interview on the 'The News Hour' in 1996 with David Gergen, editor-at-large of U.S. News & World Report <http://www.pbs.org/newshour/gergen/friedman.html> at 19 December 2008, New York Times columnist, Thomas L Friedman made the following telling comment:

> There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful.

[101] John P Hunt, 'The SEC's Proposed Rating Agency Rules: Unresolved Conflicts' (26 June 2008) Berkeley Center for Law, Business and the Economy <http://ssrn.com/abstract=1284709> at 18

addressing some of the information asymmetries that exist between issuers and investors.[102] Unfortunately many seem to believe that they did not live up to their expectations and that significant reforms are called for.

Reviews in regard to the business of credit rating were conducted in a number of jurisdictions, three of which were discussed in this contribution, namely Australia, the United States of America and the European Union. Even though the results of the reviews indicate that regulators have very much identified similar problems, the jurisdictions under discussion did not opt for a similar method of addressing these. The European Union went so far as to decide on legislative intervention and a system of penalties and sanctions, even criminal prosecution, in case of non-compliance with proposals. Australia and the United States of America, on the other hand, appear to be in favour of self-regulation and voluntary compliance with standard codes of conduct on a comply or explain basis.

A reassessment of the way in which credit rating agencies conduct their business is clearly necessary. The divergence in approach in this regard is unfortunate, however. The credit crisis is affecting the whole world and one would assume, as with matters such as global warming, that a coordinated attempt at addressing the causes thereof is necessary. This is recognised by the CESR who draws attention to the international dimension of the activities of credit rating agencies and calls for the need to 'duty [take] into account such international dimension as well as the measures already adopted in other jurisdictions with the intention to avoid inconsistencies and an un-level playing field'.[103] Rating agencies themselves are furthermore concerned that the EU proposals could impact detrimentally on their ability to operate independently and are worried that 'a country-by-country regulatory system will encourage political

December 2008, 1 highlights the significance of credit ratings in the financial industry, eg the fact that agency credit ratings figure into calculations of capital adequacy for banks and insurance companies, that institutional investor guidelines often limit holdings to securities that receive high credit ratings, that agency ratings feature in private contracts, etc.

[102] Rousseau, above n 12, 622.

[103] CESR *Response to the Consultation Document of the Commission Services on a Draft Proposal for a Directive/Regulation on Credit Rating Agencies* (Ref: CESR/08-671) CESR (2008) <http://www.cesr-eu.org/popup2.php?id=5222> at 16 September 2008.

intervention by governments trying to protect domestic financial institutions from adverse ratings actions'.[104]

The importance and power of CRAs make it essential that regulators 'get it right' when addressing concerns regarding the way in which they operate and it is important to ensure that any proposed regulation serves to improve the current system and does not come down to regulation for the mere sake of being seen to do 'something'.

In this regard it is submitted that the approach adopted by Australia and the United States of America is the more balanced approach. However, for new regulatory measures to achieve maximum success in achieving their objectives, it is essential that a uniform approach is adopted globally. Unfortunately this does not seem the be the case at the moment.

[104] Tony Boyd, 'Rating Agencies Face a Downgrade', *Business Spectator*, 14 October 2008 <http://www.businessspectator.com.au/bs.nsf/Article/Rating-agencies-face-downgrade-...> at 21 October 2008.