CPI COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
January 2014 (2)

Credit Ratings Agencies: Change by Competition Law or Regulation?

Paolo Palmigiano (Sumitomo Electric Group)
&
Simone Pieri (ICLA Italia)

Credit Ratings Agencies: Change by Competition Law or Regulation?

Paolo Palmigiano & Simone Pieri[1]

I. INTRODUCTION

Credit Rating Agencies ("CRAs") have become increasingly important in the last few years due to the increasing changes in the financial sector. The industry for ratings started in 1909 with the creation of Moody's and was followed soon after by Fitch and by Standard & Poor's. The role of these companies is essentially to try to measure, in an objective manner, the credit risk of an issuer so that investors, who otherwise would not have the appropriate information, can make informed decisions.[2]

CRAs do so by assigning credit ratings, that is ratings assessing the ability of an entity to meet financial commitments, such as repayment of principal and payment of interest. Such ratings have now become a common standard of credit risk that allows investors to make comparisons across all issuers. Letters are used to express the rating (AAA being the highest) and rated issuers can be companies, special purpose entities, states, and local governments. A credit rating may affect the interest rate an issuer pays—the better the rating the lower the interest rate (and vice versa).

CRAs were recently in the spotlight when certain securities, which were given high rating by CRAs, were downgraded to junk after the crisis, and when they downgraded Member States in Europe during the sovereign debt crisis. This has led several authorities to look more closely at CRAs and to introduce new regulations. The spotlight has also highlighted how concentrated the industry is, with two CRAs (Moody's and Standard & Poor's) controlling over 80 percent of the market, rising to over 94 percent if Fitch is included.[3]

As a consequence of such concentration, the question has arisen as to whether, in addition to regulation, competition law should have a role. This article will describe the market and its issues, consider the possible application of competition law, and then conclude with the European regulatory changes that have or are being introduced to address some of those problems.

---

[1] Paolo Palmigiano, General Counsel and Chief Compliance Officer EMEA, Sumitomo Electric Group; Simone Pieri, Chairman of the association of in-house competition lawyers, Italian section. Statements, views, and opinions included in this article are strictly those of the authors.

[2] Credit risk can be defined as the risk of loss of principal or loss of a financial reward stemming from a counterparty's failure to repay a loan or otherwise meet a contractual obligation. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation.

[3] Presentation of Prof. Karel Lannoo, Center for European Policy Studies (CEPS) to the Competition Committee the Organisation for Economic Co-operation and Development (2010), *available at* http://www.oecd.org/regreform/sectors/46825342.pdf.

II. THE APPLICATION OF COMPETITION LAW

It is worth starting the analysis from the structure of the market: many commentators seem to agree that this market is concentrated and features substantial barriers to entry.

A. The Market is Concentrated

While it is true that there are a large number of CRAs, most of them are active in a specific jurisdiction or evaluate certain financial instruments only. There are three players that have a global reach and together they control about 94 percent of the market. Since ratings have become embedded into guidelines and regulations, issuers now need to use a CRA that investors value and trust and which has the appropriate geographic reach and expertise. That limits the issuers' choice of CRAs.

B. Barriers to Entry

The market features substantial barriers to entry:

- Ratings have become embedded into guidelines and regulation, giving CRAs a captive market; regulation has created a "stamp of approval" that benefits incumbents.
- There is little incentive for companies to switch CRAs; corporate issuers build a trust relationship with one or two CRAs and are unwilling to be rated by more.
- The significant management time and costs involved in selecting and educating another CRA, as well as reputational and experience barriers faced by smaller firms, increase switching costs.
- Incumbents face less competition than they would if companies were more willing to switch.
- Size and reputation are also important; investors value CRAs having a global reach and wide expertise.
- It would take considerable time for prospective entrants to acquire the expertise and information available to CRAs on issuers.
- From an investor's perspective, there is no advantage in having a large number of CRAs as this would lead to a reduction of the information value and therefore of the core function of the CRA.

C. CRA's Business Model

If one considers these aspects, it is possible to understand why price is not the only (or main) element on which CRAs compete. Investors and issuers value qualitative features e.g. accuracy and veracity of the rating. Reputation is extremely important, making it difficult for new players to grow and it allows CRAs to charge, as many believe, high prices.

But how do CRAs finance themselves? When they were set up, investors were paying them to get ratings of issuers. The CRAs did not make ratings freely available. However, the model was not sustainable once photocopy and faxes became available in the 70's as the investors could then freely share reports and there was less demand for subscriptions. The model that has emerged is that the issuer pays for being rated and CRAs make their ratings freely available to investors and to the broader market.

This model causes several problems, including a possible conflict of interest between the issuer and the rating agencies. The issuer pays the CRA to be rated and the CRA can determine the price to rate the issuers. The perverse effect is that an issuer would be willing to pay substantial amounts to have an appropriate rating and that gives CRAs substantial negotiating power. The consequences of a bad rating can be extremely serious and can even force troubled companies into bankruptcy.

Several commentators have suggested other ways to finance CRAs. For example, going back to the "investor pays model" or a so-called "public sector model" where, recognizing the public good of the rating, national government would fund the rating costs. Neither of these two models is likely to be adopted.

D. Could Competition Law Solve the Issues That the Market Exhibits?

The fact that the market is concentrated and has certain features does not mean that there is a competition law infringement. An authority would need to prove a cartel or collusive coordination or an abuse of dominance—in our view, that is not an easy task.[4]

We cannot comment on the possibility of a cartel or of an illegal exchange of information between the CRAs as we do not have, or are aware of, any evidence proving its existence. It has been mentioned that the review of ratings and the downgrade of certain issuers by the CRAs at the same time, or shortly after each other, could be evidence that there is collusion between them. On the other hand, this could be quite normal behavior if an investment has become riskier; all CRAs would downgrade it at the same time due to a simultaneous evaluation of the credit worthiness of that issuer.

If we now consider dominance, none of the three main CRAs has, arguably, a dominant position on its own. But in an oligopoly, like the one here, it is in principle possible for the CRAs to be collectively dominant. If an authority were to take a case, it would first have to determine and prove that there is collective dominance (not an easy task in itself) and then assess the type of abuse that is being committed (again not easy). And it would also take a considerable amount of time before it would close its case. That shows why the European Commission, when considering bringing changes in this sector, has not used competition law to find a competition law infringement but has, instead, used its regulatory powers.

III. REGULATION OF CRAs IN EUROPE

The regulation of the activities of CRAs within the internal market has been a key aspect of the European debate since the beginning of the financial crisis. It is also an attempt to keep

[4] It is interesting to note that some of the barriers identified in this market are similar to the one in the report by the Competition Commission in the United Kingdom in their current market review of auditing services. In theory it would, therefore, be possible to have in the United Kingdom a market review of CRAs like the one for auditing services. Such a review would look at whether competition in the market is working effectively, examine any competition problem, identify the feature causing the problem, and propose/impose remedies. However, it seems to us that the solutions in the CRAs' market would likely be more in the regulatory space and this is where the focus of intervention has been.

pace with developments on the other side of the Atlantic. The slowness of the institutional decision-making process at the EU level does not help though, nor does the lack (sometimes) of political courage and willingness to regulate fully a very powerful global business.

Since 2008, EU regulators have put an emphasis on the need to reform the market in which CRAs operate to correct inefficiencies in their business model, while enhancing at the same time the performance and quality of the ratings. The approach undertaken at the EU level has focused on three different, but complementary, goals: to strengthen the integrity of the credit rating process through mandatory registration of CRAs; the appointment of a supervisory authority with clear and effective powers; and further measures to target over-reliance on ratings and their role.

A. Registration

At the European level, the 2008 crisis has led institutions and regulators—that traditionally preferred a "comply or explain" approach, unlike the United States—to opt eventually for administrative supervision and a mandatory registration system of CRAs.

The first CRA Regulation was adopted in 2009[5] (CRA I) and introduced, among others, a system of mandatory registration of CRAs that operate within the European Union. The process started with the submission of an application to the Committee of European Securities Regulators ("CESR"), but approval was given by the competent authority in the Member State in which the CRA had its registered office (subject to a right of other competent authorities to block that application if they had an interest). CRA I aimed to strengthen the credit rating process by ensuring that only CRAs with adequate organizational and operational models—and therefore that are able to reduce conflict of interests and guarantee transparency—could register successfully. CRA I did not, however, give a European regulator supervisory powers.

B. Supervision

In 2011, the European Security Market Authority ("ESMA"), the successor body to CESR created in 2010 to contribute further to the stability and effectiveness of the EU financial system, was given the exclusive power to register and supervise CRAs within the European Union[6] (CRA II). ESMA became legally responsible for oversight of CRAs with the ability to delegate to Member States' competent authorities. However, ESMA did not become responsible for the oversight of issuers. The latter responsibility remained with competent authorities designated under the relevant sectoral legislation for the supervision of financial institutions and entities at the national level.

ESMA can also draft regulatory technical standards in relation to the information that CRAs have to provide in their application for registration. Moreover, it can issue guidelines, carry out inspections and investigations, request information, and impose periodic penalty payments and fines. Most importantly, it has the power to suspend the use of ratings or withdraw registration upon request of competent national authorities.

---

[5] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

[6] Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies.

With the introduction of CRA I and CRA II, CRAs are now more effectively supervised. But one of the main concerns, the excessive reliance on ratings, was not addressed by CRA I and CRA II. The debate therefore continued.

C. More Recent Developments

The Commission, taking into account the European Council's October 23, 2011 comments calling for the reduction of overreliance on credit ratings, proposed further modifications to the legal framework. This led, in May 2013, to important amendments to CRA I through a new regulation and a directive[7] (CRA III). The new framework intends to achieve four main goals.

1. First, (and possibly the most important of the four goals), to ensure that investors do not mechanically rely only on credit ratings to carry out investments. According to the new framework, credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers, and central counterparties must make their own credit risk assessments and not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument. Setting up a European Rating Platform containing all the data on ratings issued by CRAs operating in the European Union should assist and let financial institutions carry out an independent assessment of ratings.

   In addition, the Commission is required to review all references to credit ratings in EU law with a view to deleting all references to credit ratings in Union law for regulatory purposes by January 1, 2020 (provided that appropriate alternatives have been identified and implemented). This could contribute to reducing the captive market that CRAs enjoy.

2. Second, to make CRAs more accountable for the ratings they provide. Under European law, CRAs can now be held civilly liable if they: intentionally or with gross negligence, infringe on certain regulatory obligations; the infringement has an impact on a credit rating; and an investor or issuer suffers damages from that infringement.

3. Third, to eliminate, or at least reduce possible conflicts of interests among CRAs, by preferring solutions that will lead to increased diversity (e.g. mandatory rotation for some types of complex structured financial instruments, the need for structured finance issues to have two ratings, and the need for issuers who have two ratings to consider appointing one CRA with a less than 10 percent market share) and stricter independence of CRAs from rated entities and competing CRAs (in particular through the limitation of cross-shareholding).

[7] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies and Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of over-reliance on credit ratings.

4. Finally, creating a more transparent and more frequent rating of sovereign debt. CRAs would also include indications as to the timing of ratings and the information to be provided to understand better the assumptions on which the ratings are based. This is aimed at reducing market disruptions.

The new framework also includes limited provisions aimed at increasing competition among credit ratings agencies such as a requirement that CRAs disclose annually the fees charged to each client for individual credit ratings, and measures to require issuers to consider appointing smaller CRAs in certain circumstances.

In CRA III, ESMA is also required to report on the possibility of establishing one or more mappings of credit ratings as an option to boost competition between CRAs by making it easier to compare ratings. ESMA will also publish an annual report on the application of the regulatory framework that will be used by the Commission to review the current status

Taking into account these documents, the Commission will then report on a wide-range of issues, including the appropriateness of additional legislative initiatives and proposals to promote competition in the credit rating market. Possible legislative measures include, for example, the creation of a European public credit rating agency and the creation of a network of smaller CRAs. The European agency would assess the creditworthiness of Member States' sovereign debt. The network of smaller CRAs would increase competition in the market. The Commission will issue reports on the feasibility of these two proposals in due course.

It should be highlighted that some of the main provisions in CRA III have been considerably watered down in the passage of the legislation from draft to implementation.[8] And if that tells us something, it is likely that a European public credit rating agency will not be created.

IV. CONCLUSIONS

Since the financial crisis, CRAs have been under the spotlight and there have been calls for changes. Various EU authorities, including competition authorities, have looked at the market. But no infringement of competition law has been found. Regulation has been the method preferred in Europe to foster changes.

As explained, the European institutions seem determined to have a comprehensive legal framework of CRAs. Although possibly not going as fast as some would want, the adopted strategy is a careful step-by-step approach to reach political agreement and meet the targets without being considered as too revolutionary by the financial industry.

The initiatives undertaken so far at European and Member States' levels have certainly reached several important results. CRAs' activities within the internal market are now more

[8] By way of example, the mandatory rotation was originally drafted to apply to a much wider category of issuance than re-securitization (which would have had a very significant impact on CRAs and issuers alike). Instead, EU institutions have arguably settled for further stigmatizing re-securitizations. Originally the draft regulations also sought to introduce a far greater role for ESMA that would have approved all rating methodologies. However, even that step received enormous criticism from issuers and agencies and proved to be completely unworkable.

regulated and supervised. The risk of a conflict of interest has decreased, whereas the quality of ratings should increase.

It goes without saying that a final evaluation will only be possible once the recent changes are fully implemented. In particular, it will have to be assessed whether and how the new provisions will actually foster any changes to market practice—for instance whether they really will result in issuers more readily appointing the smaller CRAs in future or whether any investors or issuers will take up the opportunity to bring a claim under the cause of action.

By implementing all these regulatory changes, the European Union is moving closer to the United States (and, in introducing a statutory cause of action, going further). Convergence is to be welcomed but it is probably not sufficient to address inconsistencies faced by multinational businesses and investors.

The market in which CRAs operate is global and a global approach should be the answer at the regulatory level. Supranational fora such as the G20, the Financial Stability Board, and the International Organization of Securities Commissions should go beyond the setting of a number of principles, standards, or code of conducts—the response should be more decisive and intrusive. The development of a proper global regulatory response seems to depend on political courage and willingness to set a clear framework that will benefit public and private stakeholders, at any level, in any country.