Antitrust Chronicle

WINTER 2015, VOLUME 1, NUMBER 2

Antitrust and Credit Rating Agencies

CPI COMPETITION POLICY INTERNATIONAL

COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle

January 2014 (2)

Did Credit Rating Agencies Cause the European Sovereign Debt Crisis?

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Did Credit Rating Agencies Cause the European Sovereign Debt Crisis?

Rosa M. Abrantes-Metz[1]

I. INTRODUCTION

It must not be easy being a rating agency. Where corporate debt is concerned, the major credit rating agencies ("CRAs") are said to be too slow and lagging the market. When the topic is structured finance, the agencies are said to inflate ratings to attract business.[2] And when the subject is European sovereign debt, those same agencies are said to be suddenly too conservative, issuing aggressive downgrades that destabilize the market and precipitate a crisis which otherwise would not have happened. (If only those CRAs remained slow laggards issuing inflated sovereign ratings, all would be well.)

But, in the sovereign debt case at least, is it instead that CRAs are simply the messenger, telling us what we should have known—that certain sovereign debt service may become unsustainable. Are the CRAs the villains in this story, or are they more like the little boy who announces, "the emperor has no clothes?"

The accusation that CRAs essentially caused the European sovereign debt crisis goes something like this: downgrading a sovereign causes an increase in its cost of funding, which will put further pressure on its balance sheet, which will cause further downgrades, and which, in turn, will increase its funding costs even more, until default becomes inevitable.

Such self-fulfilling arguments are neither novel nor unreasonable. The classic example is a bank run: if people think the bank is unsound, it may well consequently become unsound. Some variant of that argument may apply quite generally: if people think that XYZ Enterprises is insolvent, they will withhold financing so that it may well become insolvent. We can presumably substitute "Greece" for "XYZ Enterprises" and leave the central argument *almost* unchanged. But what really is different when the focus is sovereigns?

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[2] R. Abrantes-Metz, *Is There Misdiagnosis and Mistreatment in the Market for Credit Ratings?*, CPI ANTITRUST CHRON. (Nov. 2013). The article explains why inflation in structured finance ratings is possible given the existent monopsony power coupled with rating shopping, and proposes a specific market reform.

II. HOW SOVEREIGN DEBT RATING IS DIFFERENT FROM CORPORATE AND STRUCTURED RATINGS

Do CRA's really have market-moving influence in the case of sovereign debt? Is it true that a downgrade will cause an increase in sovereign funding costs? After all, the corollary seems to fall apart on its own face: If all the CRA's agreed to rate Greece AAA, does anyone believe that its funding costs would consequently drop to those of the United States?

When rating corporate debt, the major CRAs (S&P, Moody's, and Fitch) often have access to material non-public information, which they are permitted to consider in order to form their credit opinions. If a CRA suddenly, and apparently surprisingly, downgrades a company, it may well be revealing new information to the market. The market may react by discounting the debt of that company, which is the same thing as saying that the company's cost of funding may consequently increase.

This argument would seem to be more reasonable the smaller the company in question is. Large companies such as General Electric or Exxon are under constant scrutiny. Equity analysts follow them closely. They are publicly traded and must satisfy stringent financial disclosure regulations. But smaller companies invite less scrutiny, and any unanticipated rating action might be expected to carry more weight where they are concerned.

Likewise, the argument may be more reasonable where the investor base is less sophisticated. Smaller "mom and pop" investors may put more weight on CRA opinions than do large, sophisticated investment houses and banks which often conduct their own credit analysis. You and I may have no choice but to consider the CRA designation of "junk status" when buying, or not buying, a security. But does Goldman Sachs make its investment decisions based on the opinions of S&P, Moody's, or Fitch?

Sovereign debt is in an altogether different category. First of all, as it is clear in their sovereign rating methodologies, CRAs are privy to no private information.[3] They are the first to admit that their information is limited to what is known by the market. It is also obvious that this should be the case in this particular market. And, as far as "market scrutiny" is concerned, the budgets of the major sovereigns are topics of constant discussion. A day hardly goes by without some commentary on the fiscal health of European sovereigns. Finally, the overwhelming tonnage of sovereign debt is held by banks—not individual, unsophisticated investors. Such investors are, presumably, the least likely to be influenced by an opinion from a CRA.

Against this backdrop, if a CRA were to take an inexplicable, spurious, or "random" rating action on a sovereign, it is not at all clear why the market would—or should—pay any attention to it. Would the funding costs of the United States change if the CRA's rated it BBB instead of AAA? For example, when S&P downgraded U.S. sovereign debt from AAA to AA+ on August 5, 2011, were we aware of subsequent increases in the U.S. cost of funding caused by the downgrade?[4]

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[3] *See* Sovereign Bond Ratings Methodology, Moody's Investors Service, September 12, 2013.

[4] *See* S&P's Rating Announcement *available at* http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563.

While I confess to being skeptical that a CRA would have the means to provoke a market reaction on sovereign debt, I am even more skeptical that it would have a reason to do so. Much has been made of the "conflict of interest" inherent in the issuer-pays model of the major CRAs. Put simply, when the issuers of the debt pay for the rating, there may be pressure for the rating agency to assign an upwardly biased rating. The CRA's are not paid for their sovereign ratings, so in the first instance there is no such conflict of interest. The Greek government does not pay for its rating, and hence cannot exert any direct financial pressure for a higher-than-otherwise rating.

But this does mean that the CRAs are under no pressure where their sovereign ratings are concerned. And it certainly does not mean that the CRAs have any incentive to assign low sovereign ratings. The fact is that the sovereign ratings are sometimes inputs into other ratings. In the case of Moody's, for example, they employ an explicit "sovereign ceiling," representing the highest possible rating which can be achieved by domestic issuers under that sovereign. For example, if the sovereign ceiling is A3, then no domestically based credit (including structured credits) can be rated higher than A3; further, no level of credit enhancement could achieve a rating above A3. While that ceiling is often several rating categories ("notches" in the parlance of rating agencies) above the sovereign rating itself, as a practical matter very few corporate issuers are rated above their sovereign.

Therefore, when the CRA downgrades a sovereign, that puts some downward pressure (which may or may not be binding) on all the ratings—corporate, sub-sovereign, government related, and structured—subject to that sovereign jurisdiction. If the CRAs are conflicted by the issuer-pays model to always assign the highest possible ratings they can, then the last thing they would want to do would be to downgrade a sovereign. Further, downgrading a sovereign can prompt substantial—and expensive—analysis to determine any and all impacted credits; credits which may then require downgrades themselves.

So not only do the CRAs have no incentive to lower sovereign ratings, they have every incentive—other than reputational—to leave them alone or raise them. Rating every government "AAA" would certainly be the path of least resistance for a CRA. It just wouldn't be credible.

Following this line of reasoning, the narrative that CRAs would spuriously downgrade European sovereigns, and that the market would consequently discount the sovereign debt, seems dubious on both points. The CRAs have only a long-term reputational incentive to downgrade sovereign debt. And this incentive would have to be measured against short-term pecuniary incentives not to—which suggests it is unlikely a CRA would aggressively downgrade any sovereign ahead of (let alone contrary to) prevailing market sentiment. And since the CRA would not claim any private information, it seems unlikely that the sophisticated investors who overwhelmingly hold the sovereign paper would necessarily change their pricing of this debt as a result.

Fortunately this question can be addressed, if perhaps not ultimately answered, through a fairly standard empirical analysis known as an "event study." Market prices— bond yields or Credit Default Swaps ("CDS") spreads—can be evaluated in a window of time surrounding a rating action to see if there is a statistically robust response pattern. If CDS spreads, which measure the price of insurance against default by an underlying issuer, routinely increase

following a downgrade of the issuer's rating, then such evidence would appear consistent with the argument that the CRAs at least *could* precipitate a sovereign crisis. On the other hand, if there is no relationship between rating actions and spread changes, that could be taken as supporting evidence against the argument.

Economists at Moody's recently conducted an event study of exactly this type, in the context of the CDS market, exploring the empirical impact of credit rating actions on sovereign markets.[5] A rating action includes not only upgrades and downgrades, but also outlook and watchlist assignments that may anticipate rating changes. The paper studies a data set from 2005 through early 2012, and examines the response of the CDS market to sovereign credit announcements of the three major rating agencies—Moody's, S&P, and Fitch. CDS spreads represent the direct prices of credit risk and, therefore, if a rating action *causes* changes in the market perception of credit risk, we would expect to see direct evidence in the CDS market.

Using a standard event study methodology, the study finds that for EA-12 countries[6] there is a small portion - 5 percent - of negative credit events statistically significantly associated with CDS excess returns, consistent with the hypothesis of little or no impact of negative sovereign rating actions. Similar results are found when sovereign rating actions are positive.

The study also finds that sovereign rating actions only have a statistically significant effect on returns of smaller or lesser developed countries, and only if the rating action is credit negative. These results provide supporting empirical evidence that, especially for the core European sovereigns, ratings do not seem to impact market credit perceptions beyond what would be randomly expected.

III. CONCLUDING REMARKS

Blaming the rating agencies for the difficulties of Greece, Italy, Spain, and Portugal truly seems like a case of blaming the messenger. High debt-to-GDP ratios, large and rapidly growing pension and healthcare expenditures, and slow economic growth and consequent tax revenue are facts, not opinions. Investors would discount the debt of these countries no matter what the CRAs said, or even if the CRAs said nothing at all.

Credit rating agencies are not perfect. They may even be in need of significant reform. But, in this case, it seems more likely than not that they are convenient scapegoats, and not villains.

[5] *The Price Impact of Sovereign Rating Announcements*, a Moody's Special Comment, was published in October of 2012.

[6] The group of EA-12 countries is composed of Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and Greece.

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Market Power in the Credit Rating Industry: State of Play and Proposal for Reforms

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Market Power in the Credit Rating Industry: State of Play and Proposal for Reforms

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I. INTRODUCTION

In recent years, the Credit Rating Agencies ("CRAs") have been in the eye of the storm. Some argue that CRA rating errors—symptomatized by rating inflation or deflation—originate in excessive competition. This paper argues that the low level of competition in credit rating is a better explanation for rating this phenomenon.

To show this, the present paper is divided in seven sections. Section II gives a brief overview of the credit rating industry. Section III describes CRAs rating errors, focusing on rating inflation and deflation. Section IV argues that the cause of rating inflation and deflation is due to CRAs' significant market power, in a sector where the process of competition by reputation fails to work. Section V looks at structural features of the industry specifically in the context of conflicts of interests. Section VI argues that more competition in credit rating services is warranted, reviews recent regulatory changes that purport to promote competition, and offers additional suggestions for reform, while Section VII concludes.

II. OVERVIEW OF THE CREDIT RATING INDUSTRY

On a daily basis, economic agents issue thousands of financial products in the form of bonds, shares, securities, etc. to fund their economic activity. Those financial products are sold to investors who expect a return on investment. Importantly, because issuers of financial products are heterogeneous, investors seek information on the former's creditworthiness to make the best possible investments. Given the ever-growing complexity of financial products, the limited expertise of many investors, and the costs of revealing information, the evaluation of issuers' creditworthiness has been delegated to specialized intermediaries[2] known as CRAs.

CRAs assess and provide information on one key dimension of credit worthiness, i.e. the default risk of issuers. CRAs' assessments are expressed in the form of ratings, which classify issuers and financial products in different categories of risk of default, usually from AAA to D (Default). Those ratings are subsequently disclosed to the market. Importantly, investors do not pay for ratings. CRAs are financed by issuers (and by the banks that act on their behalf), with the exception of certain products like sovereign ratings.

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[2] D. Diamond, *Financial Intermediation and Delegated Monitoring*, 51(3) REV. ECON. STUDIES 393-414 (1984).

III. CREDIT RATING ERRORS

A. Ratings Over an Economic Cycle

In recent years, policy makers have pointed finger at CRAs, criticizing their inability to anticipate major credit defaults, such as the collapse of Enron in 2001 or that of Lehman Brothers in 2008. More importantly, CRAs that are supposed to assess credit default risks through an economic cycle—on a given time horizon which spans usually three to five years—have tended to rate "over" the cycle, being over optimistic in periods of economic growth and, in contrast, over pessimistic in times of economic decline.

In sovereign ratings, CRAs rate the probability of sovereign default in the long run. In principle, those ratings should disclose public information on the debt sustainability of a particular country. They should be based exclusively on fundamental variables, thus sweeping away rumors that often trigger financial crises (for example in Thailand 1997 or in the United Kingdom in 1992). By revealing public information and, hence, reducing the degree of asymmetric information as well as transaction costs, CRAs contribute to higher financial stability.

However, since the beginning of the subprime crisis in 2008, many studies[3,4] have observed an increase in ratings frequency—*i.e.* the number of ratings issued in a year—and, with it, a multiplication of downgrades. Frequent rating reviews conflict with the long-term perspective that CRAs should adopt, because a short time frame may mislead them in the assessment of long-term structural factors.

In this regard, several studies have documented that sovereign debt ratings appear to vary over the cycle and, even worse, to be pro-cyclical—leading to an amplification of economic cycles and contributing to deteriorating financial stability.[5] Moreover, several papers and reports bring evidence that CRAs deliver less accurate rating of commercial bonds during booms.[6] The IMF[7] has documented that most of the residential MBS issued in the United States that were rated AAA before the recent financial crisis are now rated below BBB. According to White,[8] overoptimistic ratings have exacerbated the subprime crisis.

B. Rating Errors' Costs: Financial Instability

CRA ratings may thus undermine financial stability. One of the main reasons is the so-called "over-reliance" of investors on ratings who take CRAs assessments for granted, regardless

[3] R. Arezki, B. Candelon, & A. Sy, *Sovereign Rating News and Financial Markets Spillovers: Evidence from the European Debt Crisis,* IMF Working paper (2011).

[4] A. Afonso, D.Furceri, & P. Gomes, *Sovereign credit ratings and financial markets linkages: Application to European data*, 31(3) J. INT'L MONEY & FIN. 606-638 (2012).

[5] Of course, we can hardly imagine CRAs to be counter-cyclical as they are under a duty to disclose correct information.

[6] H. BAR-ISAAC & J. SHAPIRO, RATINGS QUALITY OVER THE BUSINESS CYCLE (2010).

[7] *The Uses and Abuses of Sovereign Debt Credit Ratings*, IMF Global Financial Stability Report, Ch. 3, 85-122 (2010).

[8] L. White, *The Credit Rating Agencies*, 24(2) J. ECON. PERSPECTIVES 211-226 (2010).

of whether they are sound or unsound. For sovereign debt ratings, Arezki et al.[9] have shown that downgrades turn out to have stronger effects than upgrades.

In particular, downgrades yield two types of spillover effects across the economy: First, rating changes diffuse geographically.[10] A downgrade in Greece may have a direct negative impact on the rating of other European countries perceived as weak (by virtue of a "contagion" effect) and a direct positive impact on other European countries perceived as strong (by virtue of a "flight-to-quality" effect).

And, second, downgrades also diffuse across financial markets through balance sheets. The downgrade of Greece may, for instance, lead to an increase in sales of Greek Credit Default Swap ("CDS"). But it also negatively impacts the situation of the financial sector; non-performing loans deteriorate the balance sheets of financial institutions, leading to a decrease of stock market indexes. Both spillovers undermine financial stability.

IV. MARKET POWER IN CREDIT RATING

Our hypothesis is that rating over the cycle is a by-product of incumbent CRAs' market power, held in an industry where competition takes place on quality, rather than on prices.[11] In the credit rating industry, market players compete predominantly on rating accuracy. As information goods are experience goods, investors cannot assess rating quality *ex-ante*. Furthermore, they cannot rely on rating models as a proxy, as CRAs keep their models private.

Rating quality can thus only be evaluated *ex post*, on the basis of the CRAs' track record in rating financial products. This means that *ex post* forecast accuracy and reputation should drive competition in the credit rating industry. In a hypothetically competitive industry, high forecast accuracy should build a good reputation (among investors), which, in turn, should grow market share (with issuers). By parity of reasoning, poor forecast accuracy should lead to reputational damage (among investors), which should eventually translate into loss of market share (with issuers) and possibly lead to market exit.

The market for audit services brings ample proof of this type of reputational competition. Following the Enron scandal, Arthur Andersen's reputation was so damaged that its sole option was to exit.[12] Similarly, in Japan, the failures of PwC's subsidiary have led to a well-documented spill of clients towards rivals.[13]

In our view, a similar process of reputational competition should take place in the credit rating industry and, in turn, limit rating errors or, to be more accurate, limit rating errors over the cycle. However, quite strikingly, CRAs' inability to provide accuracy in their forecasts during

[9] Arezki, et al., *supra* note 3.

[10] J. Aizeman, M. Binici, & M. Hutchison, *Credit ratings and the pricing of sovereign debt during the euro crisis*, 29(3) OXFORD REV. ECON. POL'Y 582-609 (2013) and Arezki et al., *supra* note 3.

[11] N. Petit, *Credit rating agencies, the Sovereign Debt Crisis and Competition Law*, 7(3) EUR. COMPETITION J. 587-632 (2011).

[12] S. Krishnamurthy, J. Zhou, & N. Zhou, *Auditor Reputation, Auditor Independence and the Stock-Market Impact of Andersen's Indictment on its Client Firms*, 23(2) CONTEMPORARY ACCOUNTING RES. 465-490 (2006).

[13] D. Skinner & S. Srinivasan, *Audit Quality and Auditor Reputation: Evidence from Japan*, 87(5) ACCOUNTING REV. 1737-1765 (2012).

the recent economic crisis, and the ensuing reputational damage that they should have suffered vis-a-vis investors, have not translated into lower rating sales with issuers.

Our explanation for this puzzling finding is that, absent competition from actual or potential competitors, issuers have nowhere to divert ratings orders and punish incumbent CRAs. In particular, external competition from new entrants is illusory. Issuers cannot divert away rating orders towards external players, for the latter face very high and insuperable barriers to entry. Moreover, internal competition among incumbent CRAs is ineffective. Issuers cannot play one existing CRA against the other, for each incumbent CRA is bound to make the same rating errors due to conflicts of interests (see below).

The hypothesis that neither external nor internal competition is sufficiently strong to discipline incumbent CRAs is backed by market data. First, the market for credit rating services is heavily concentrated. While there are more than 70 CRAs throughout the world, the "Big Three"—Moody's, Standard & Poor's, and Fitch—account for 94 percent of the global market. Moody's and S&P each hold a 40 percent market share. Fitch, which became the third important player in the early 2000s, is reported to control 15 percent of the market. These market shares have remained remarkably stable in recent years. Moreover, the Big Three CRAs are global players covering a broad range of products and markets; the other CRAs are either regional or product-type specialists.[14]

Second, the credit rating market exhibits several important barriers to entry. Above all, the superior informational expertise of incumbent CRAs clearly limits entry. This is a result of (i) the time needed for prospective entrants to amass issuers' information, (ii) the availability of experienced analysts on the labor market, and (iii) the time needed to establish appropriate rating methodologies. Other barriers to entry include (i) brand loyalty towards incumbent CRAs, (ii) transaction costs savings achieved by issuers in dealing only with a few CRAs, and (iii) regulatory obstacles in the United States and Europe—where only a limited number of CRAs (respectively 10 and 37, though in Europe 16 of 37 are controlled by Moody's, S&P, and Fitch) are officially recognized as credit assessment institutions. The cost of establishing a new rating agency has been estimated in the ballpark of EUR 300-500 million over five years by the European Commission. Empirically, recent attempts to create new agencies confirm this. For instance, in 2013 the consultancy firm Roland Berger failed to raise enough capital to set up a rating agency capable of competing with the big threes.

Third, and importantly, CRAs are protected by a somewhat original barrier to exit that economists label "institutionalization." Many legal instruments (*e.g.* sector-specific legislation on investment funds and retirement provision institutions), but also guidelines and decisions of supervisory authorities, refer to external credit ratings. For instance, the amount of capital that banks must hold is, in some cases, determined by their external ratings. This, in turn, channels a captive demand for ratings towards CRAs, and CRAs become unavoidable trading partners for issuers (a phenomenon known as "over reliance"). Issuers no longer perform their own credit assessment, and mechanically rely on external ratings. Thanks to this, the threat of exit in a

[14] IMF, *supra* note 7, Ch. 3.

competitive market that drives market players to provide high quality ratings becomes moot, as CRAs insulated from market entry know they will inevitably get some business.[15]

With this background, the case can be made that CRAs enjoy significant market power by virtue, in particular, of high barriers to entry and exit. And this market power can likely be observed empirically as CRAs achieve "extremely high profit margins"[16] and their market shares are remarkably stable. Significant market power has weakened the competitive pressures in the credit rating market, leading to a decline in rating quality.

V. CONFLICTS OF INTERESTS

Several structural features of the industry create an observed "rating inflation" for specific complex, structured products like mortgaged-backed securities ("MBS") or credit default swaps ("CDS") that are issued by a limited number of large companies,[17,18] particularly during economic booms. In particular, the issuer-pays rule, *i.e.* CRAs are remunerated by issuers, not investors—combined with the discretionary possibility for issuers to withhold the disclosure of ratings produced by CRAs—gives rise to a conflict of interest which creates perverse incentives in the industry, and nurtures rating inflation.

On the one hand, issuers need good rates to sell their products and to develop the market for complex products. On the other hand, CRAs are not sanctioned if they fail to provide accurate ratings because they are protected by market power. Rating inflation is thus a (short-run) profitable strategy for both issuers and CRAs.

This is further exacerbated by the discretion left to issuers to disclose or not disclose a rating. A CRA that doesn't follow a "rating inflation" strategy would likely be sanctioned by issuers who would block the disclosure of its ratings, and turn to another incumbent CRA. As a result, such as with a Chamberlinian oligopolistic interdependence setting, each incumbent CRA understands that it makes no sense to deviate from a rating inflation strategy and issue uninflated ratings, for fear of being marginalized in the market. A more rational short-term strategy for each CRA is to follow the rating inflation strategy desired by issuers. Moreover, this conflict of interest has endured, because CRAs are protected from external competition by high barriers to entry.

Importantly, again, we want to stress that this conflict of interest is not caused by competition but rather by its absence. Rating inflation does not stem from the fact that issuers can "shop around" for the best possible rating[19] but by the lack of competition that does not discipline CRAs that choose to inflate their ratings for a short-term benefit. If the market has the ability to sanction poor rating quality, CRAs would have no other option than to compete on the

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[15] J. Hörner, *Reputation and Competition*, 92(3) AMER. ECON. REV. 644-663 (2002).

[16] P. Bolton, X. Freixas, & J. Shapiro, *The Credit Rating Game*, 67(1) J. FINANCE 85-111 (2012).

[17] V. Skreta & L. Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation*, 56(5) J. MONETARY ECON. 678-695 (2009).

[18] J. Mathis, J. McAndrews, & J.-C. Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?*, 56(5) J. Monetary Econ. 657-674 (2009).

[19] Mathis, et al. show that rating inflation is not primarily caused by competition for rating. Even in the case of a monopolist, maintaining its reputation is not sufficient to discipline the CRA that will behave opportunistically, and opportunism by the CRA may inflate ratings particularly when rating complex products is an important source of income for the CRA, *Id.*

merits, *i.e.* on ratings accuracy. It should be noted, however, that conflicts of interest cannot explain the deterioration of sovereign debt ratings, as countries do not pay for ratings.

VI. REMEDIES

In short, the functioning of the credit rating market is suboptimal. Rating models are biased toward the short run, and exhibit pro-cyclical movements. Besides, CRAs are sheltered from competition, which has led to a decline in rating accuracy. We believe that the credit rating market would benefit from more competition, together with a series of structural reforms. In a nutshell, the regulatory framework should help establish a "competition by reputation" environment by (i) rewarding those CRAs who produce accurate ratings; and (ii) sanctioning those who fail to do so.

The below discussion is organized in three parts: first, we propose amendments to rating models; second, we recommend the disclosure of all ratings; and third, we assess recent structural amendments that seek to promote competition.

A. Forward-Looking Credit Rating Models

Given that CRAs have market power, their ratings have a strong influence on financial markets. For that reason, it is of prime importance that CRAs have a long-run rating perspective. Theoretically, this means that CRAs should use forward-looking rating models that assess the long-run refinancing capacity of the issuer/firm/country. This implies, for instance, that a country exhibiting a high public debt should not be automatically downgraded. A downgrade should only occur if the country's public debt undermines *permanently* its refinancing capacities, i.e. its sustainability.

Equally, CRAs should, by all means, avoid using backward-looking rating models, which risk annihilating the effects of stabilization plans, hence creating "double dip" recessive situations or self-fulfilling prophecies. For example, a country faced with refinancing problems at the early stage of a public stabilization program risks being strongly affected by such a downgrade event, though the rating change—which is based on information prior to the stabilization program—says nothing of the future of long-term refinancing capacity of this country.

In short, both the models used by CRAs and the time horizon of those models have critical importance. The model should take into account not only the current situation of the issuer but also the future consequences of a rate review on its refinancing capacity. For corporate ratings, there are numerous evidences of non-Markovian transition matrixes,[20,21] meaning that the rating itself is not sufficient to explain the transition from one grade to another but that history—especially downgrades—matters. In other words, two firms with the same rating, but with a different rating history, have different probabilities of being downgraded in the future, implying that there is additional information beyond ratings (rating history) that is useful to assess the creditworthiness of an issuer. Non-Markovian ratings mean that there is information

[20] D. Lando & T. Skødeberg, *Analyzing Rating Transitions and Rating Drift with Continuous Observations*, 26(2-3) J. BANKING & FIN. 423–444 (2002).

[21] H. Frydman & T. Schuermann, *Credit Rating Dynamics and Markov Mixture Models*, 32(6) J. BANKING & FIN. 1062-1075 (2008).

that is not embedded in the current rating, precisely because the rating model does not take into account all future consequences.

To remedy both these modeling issues, we suggest the following series of measures:

1. Certification process for credit rating models

CRA ratings should be supported by adequate rating models. Of course, we are well aware that rating models are private and that they constitute the core business of CRAs (from which they are making profit). Public disclosure is thus not an option. That said, we propose, as in many other industries, a model certification process, performed by an independent body (ESMA or IMF for example). This procedure would guarantee the quality of the rating model as well as financial stability. Besides, by accepting this certification process, CRAs would gain credibility and improve their reputation. Hence, it would be in the CRAs' best interests to support (and possibly initiate) such a certification process.

2. Appeals against CRA ratings

In addition to this certification process, we also support the introduction of a possibility of "appeal" if there is disagreement between a CRA and the rated country/firm. The U.S. Treasury did just this following S&P's downgrade. But this second review was entrusted to the Securities and Exchange Commission ("SEC"). In our proposed system, the appeal should be dealt with by the organ in charge of the certification process, which could unambiguously confirm/modify the challenged rating within a reasonable timeframe.

3. Protection of issuers under stabilization plan

In addition to modeling issues, it is open to question whether all ratings should be disclosed to the market place. Of course, the public disclosure of ratings is beneficial to both investors and rated entities (so they can improve their situation). But we believe that a CRA's downgrade should nonetheless be suspended for a fixed period during stabilization programs in order to avoid arbitrage.

We do not favor a *sine die* disappearance of ratings in cases of sustainability issues, but instead a provisional suspension of ratings, in order to preserve the chances of international aid programs to yield positive effects. This would prevent the destructive consequences of a "double dip" event; i.e. a downgrade, followed by an international program, which is immediately annihilated by a second downgrade.

Our proposal is similar to the U.S. Chapter XI legislation that guarantees state protection to any firm that faces potential bankruptcy risks. In recent times, the European Union has adopted similar measures in relation to sovereign ratings: CRAs shall not issue more than three unsolicited sovereign ratings a year (before the WE, on Fridays by close of business). Moreover, they should establish *ex ante* a yearly schedule for those three ratings.

4. Benchmarking CRAs' performance in a standard and comprehensive way.

To create and stimulate competition on the merits, it is important that market players be able to evaluate the rating accuracy of the various CRAs. To date, CRAs have measured their

performance on the basis of Gini coefficients.[22] In our view, performance assessments should be performed more systematically and in a standardized way, allowing issuers to compare rating quality. This is a prerequisite to promote competition on the merits.

B. Mandatory Rating Disclosure

Credit ratings are paid for by the issuers and subsequently disclosed publicly—upon agreement of the issuer—making a rating a public good. This "issuer pays rule" has created perverse incentives. In our view, it is important to expropriate the issuer from the choice of either disclosing a rating or not, and make rate disclosure mandatory. This measure, together with appropriate instruments to compare rating performance (see point 3 above) and measures to favor entry and competition (see below) will defuse incentives to inflate ratings.

C. Structural Measures to Promote Competition

In addition to modeling issues, structural reforms may also help promote competition. Earlier this year, the European Union adopted a new regulatory framework entitled the credit rating regulation (hereafter, the "rating regulation").[23] This framework contains a raft of new measures that seek to promote competition by ensuring CRAs' accountability, reducing overreliance on ratings of public and private financial institutions, and promoting competition. We review them in turn, and provide a first assessment.

1. "Enabling" competition from internal ratings: the "over-reliance" problem

The rating regulation a number of measures that seek to reduce "overreliance," in line with earlier G20 commitments. These measures try to promote ratings competition by prompting financial institutions to vertically integrate and substitute internal, or in-house, ratings for competing external ratings. The primary requirement is that financial institutions make their own credit risk assessments, and not mechanically rely on credit ratings.[24]

In addition, EU supervisory authorities (like ESMA or the ECB) should avoid references to external ratings in official documents. Moreover, because reliance on external ratings might be imposed by the financial regulation, the EU Commission has been tasked to review—and as the case may be to purge—legal instruments that refer to external ratings.

To help investors perform their own assessments, the rating regulation additionally requests issuers to provide information on the performance and quality of the underlying assets, in order to reduce dependence on external credit rating, and help investors perform self-assessments that compete with CRAs assessments. The rating regulation explains that this may

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[22] The Gini coefficient measures the cumulative default rate for each rating category A relative to the number of issuers in each category. A coefficient close to 1 means that defaults are concentrated in low rating categories indicating a high rating accuracy. A low coefficient means that defaults are equally spreads across rating categories, indicating a poor performance.

[23] *See* Regulation (EU) 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on Credit Rating Agencies.

[24] *See* Article 5b) of the rating regulation. This is also a requirement of Capital requirement directive IV requiring banks to rely on their own internal credit opinions (Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013), §§73 and 77.

also increase the competition between credit rating agencies, because it could lead to an increase in the number of unsolicited credit ratings.

2. "Promoting" competition in external ratings: the "rating inflation" problem

The new regulatory framework also seeks to promote competition in external ratings or, put differently, competition among CRAs. To that end, the rating regulation first imposes a *multi-sourcing* requirement. In so far as structured finance products are concerned, issuers must engage at least two different CRAs for the rating of financial instruments.[25]

The rationale behind this new requirement is to improve quality by creating competition within the rating of a particular financial product. The regulation seeks to reveal possible differences in assessment, and help issuers dismiss overoptimistic ratings given by a conflicted CRA (provided that information is disclosed and that the rating model is correctly specified, as we argued above). Given the abovementioned problem of interdependence in rating inflation, however, one may actually question whether the creation of small duopolies for the rating of financial products will promote, rather than undermine, competition.

To the same end, the rating regulation provides that when an issuer appoints two agencies, he shall consider appointing a third one with no more than a 10 percent market share.[26] This measure seeks to promote external competition by giving small CRAs the opportunity to gain market shares, thereby increasing competition in the long run. To help issuers identify small CRAs, the ESMA regularly publishes a list of CRAs accompanied with market shares.[27] Again, however, the market share transparency mechanism could entitle incumbent CRAs to identify small cheating CRAs that do not follow a rating inflation strategy, and in turn punish them more effectively.

In the same vein, the rating regulation forbids CRAs to price discriminate. Issuers should set fees based on actual costs, to ensure "fair competition."

Finally, another regulatory measure designed to foster competition is the rotation mechanism, which forbids financial institutions to use the same CRA for more than four years, and forces them to change CRAs after the expiry of this period. The scope of this rotation rule is limited. It only applies to a subset of complex structured products called "re-securitisation." The European Union has decided to restrict the rotation rule to a limited category of products in order to do empirical testing. There will be a review of the rotation mechanism in 2016, to assess whether an extension to other financial products is warranted.

On substance, the goal of the rotation mechanism is to reduce risks of complacent ratings by conflicted CRAs, who arguably seek to build long-term relationships with issuers. To that end, the rotation mechanism artificially recreates a process of competition for the market every four years, by capping contracts and forcing issuers of re-securitization to switch. Obviously, it is not possible for an incumbent CRA to re-rate the same issuer after four years. And the rotation rule will not apply to small CRAs or issuers that use four CRAs or more.

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[25] *See* Article 8c of the rating regulation. *See also*, §28 of the Preamble of the Regulation.

[26] *See* Article 8d of the rating regulation.

[27] The rating regulation additionally provides for the publication of all ratings on a European rating platform, to help small CRAs gain visibility.

The impact on competition of the rotation mechanism is debatable. If we are right that there is not enough competition in the market—in particular external competition (which is our hypothesis)—this measure may erect an additional barrier to entry, freezing the market shares of the three incumbent CRAs and institutionalizing rotation between the main players. In this scenario, CRAs will have even less need to compete on quality, for the rotation rule will automatically provide clients regardless of past performances. Thus, effective external competition is a prerequisite for this measure to work. In contrast, if there is enough competition on the market (which is not our hypothesis) one may question the need for an additional layer of competition. Issuers will simply select the best raters and the market will discipline the CRAs.

3. Miscellaneous

The rating regulation finally contains rules on shareholdings, which purport to sever structural ties between CRAs and issuers and among CRAs. These measures seek to limit risks of concerted conduct (*i.e,* rating) between CRAs and issuers, and among CRAs. The new framework also contains rules on civil liability, which provide that CRAs should be liable for damages if they commit an infringement intentionally or with gross negligence.[28] Increasing the accountability of the CRAs is indeed a means to incrementally discipline agencies.

VII. CONCLUSION

There is a large consensus on the decline of external rating accuracy in recent years. However, the literature is divided on the causes of this decline. In this paper, we argue that the credit rating industry has been sheltered from effective competition by high barriers to entry. In turn, the "competition on the merits" mechanism that should have ensured rating accuracy has failed to work properly.

Given that external ratings are essential for well-functioning financial markets, increasing competition in the rating industry is of prime importance. To that end, investors and issuers should be able to sanction poor performing agencies and reward good performing ones. In addition, measures should be adopted to reduce the mechanistic reliance of financial institutions on external ratings. Regulators across the world should keep those objectives in mind when mulling options for reforms in the credit rating industry.

[28] *See* Article 35a of the rating regulation.

CPI COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle

January 2014 (2)

Credit Ratings Agencies: Change by Competition Law or Regulation?

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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.

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[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

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[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.

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[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).

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[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.

CPI COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
January 2014 (2)

Regulating the Credit Rating Agencies? Less Would Be More

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Regulating the Credit Rating Agencies? Less Would Be More

Lawrence J. White[1]

I. INTRODUCTION

The three major credit rating agencies ("CRAs")—Moody's, Standard & Poor's ("S&P"), and Fitch—continue to receive widespread media and policy attention. Since 2008 the Securities and Exchange Commission ("SEC") has expanded its regulation of the CRAs—partly on its own initiative and partly as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Injured investors—primarily pension funds—have sued the CRAs. In early 2013 the U.S. Department of Justice sued S&P for fraud. All of these events have attracted substantial media attention, as do proposals for new CRAs.

The major CRAs surely wish that all of this attention would evaporate; but it is likely to persist. Their excessive optimism with respect to mortgage-related securities in the middle years of the decade of the 2000s made them important for the housing bubble of that era and then in the financial crisis that followed.

However, as many disgruntled commentators have noted, despite the heightened attention little has changed: The same three CRAs still dominate the ratings business. Their ratings—and especially downward changes in their ratings—still attract media attention and often move markets. And the same troubling business model that seemed to encourage that excessive optimism—they are paid by the issuers of the bonds that the CRAs rate—still prevails among the major CRAs and even among most of the smaller ones.

So, what needs to change? Is more regulation needed? Better regulation? Maybe less regulation? Is there a role for antitrust? After all, there are only three CRAs that dominate the ratings business—and have done so for decades. Is more competition needed? If so, how might it be created?

This essay will argue that public policy should remove the pedestal on which past policy has placed the major CRAs. Their deification should be revoked, which should allow less (but better focused) regulation and more competition.

II. WHAT DO THEY DO?

At the heart of any lending/borrowing relationship is the following question: Will the borrower repay the lender? To try to determine the answer, lenders usually gather and assess information about the borrower: before deciding whether to make the loan, and then (if the loan is made) during the time that the loan is outstanding. Some lenders are able to do this themselves; others turn to third parties for help.

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With respect to bonds—which are loan instruments between the companies or governments that borrow by issuing (selling) bonds and the investors that lend by buying the bonds—many issuers and investors have traditionally looked to CRAs for help. John Moody was the first to offer publicly available assessments—"ratings"—of railroad bonds in 1909. Other information companies—notably, Standard, Poor's,[2] and Fitch—entered the ratings business over the following 15 years. They earned their revenues by selling their ratings to investors. In modern parlance, they had an "investor-pays" business model.

The major CRAs never were and still are not the only source of creditworthiness information about bonds. Large institutional investors[3]—such as banks, insurance companies, pension funds, and various kinds of investment funds – often have the scale to support skilled in-house personnel to make the assessments. There are also smaller creditworthiness advisory firms—which may or may not describe themselves as CRAs but perform similar assessments—to which bond investors may turn. Large securities firms employ "fixed-income analysts," who provide creditworthiness assessments of bonds for their firm's investor clients, as well as for the firm's securities traders.

But, still, the three major CRAs continue to dominate the ratings area. How and why is this so?

III. SOME HISTORY

For the first few decades of the major CRAs' existence the use of ratings by investors was wholly voluntary. However, starting in the 1930s important categories of institutional investors—initially banks, and then insurance companies, pension funds, broker-dealers (securities firms), and money market mutual funds—were required by their prudential regulators to pay attention to the major CRAs' ratings of the bonds in which those institutions might invest. Thus, from the 1930s onward, the major CRAs had a guaranteed audience among prudentially regulated institutional investors for their ratings. Concomitantly, smaller creditworthiness advisory firms were at a substantial disadvantage vis-à-vis the major CRAs, since the former's views/opinions/ratings would carry less weight with those regulated institutional investors.

This arrangement was formalized in 1975, when the SEC created the category of "nationally recognized statistical rating organization" ("NRSRO"), for the purposes of designating exactly which CRAs' ratings should be heeded by the prudentially regulated financial institutions. The SEC immediately designated Moody's, S&P, and Fitch as NRSROs—which then became a barrier to entry: During the following 25 years the SEC designated only four additional CRAs as NRSROs; but mergers among the new designees and with Fitch caused the number of NRSROs to shrink back to only the original three by year-end 2000.

In the aftermath of Enron's November 2001 bankruptcy, the media discovered that the three major CRAs had maintained "investment grade" ratings on Enron's bonds until five days before that company's bankruptcy filing. In the Congressional hearings that followed, the

[2] The two companies merged in 1941.

[3] The bond markets are overwhelmingly institutional: Of all bonds that are held by U.S. entities, over 85 percent (by value) are held by financial institutions. Thus, the typical bond "investor" is (or ought to be) a professional manager of a financial institution's bond fund.

NRSRO system and the SEC's opaque administration[4] of it was aired. In response to Congressional pressures, the SEC designated a fourth NRSRO in 2003 and a fifth in 2005 but retained its opaque administration.

Unsatisfied with the SEC's response, the Congress enacted the Credit Rating Agency Reform Act ("CRARA") of 2006, which requires the SEC to establish a clear application process for firms that want to become NRSROs and a set of criteria for the SEC to use in assessing those applications.[5] Since 2006 the SEC has approved six additional NRSROs; one subsequently requested decertification, so there currently are ten NRSROs. Nevertheless, the three major CRAs have continued to dominate: As of 2012, of all of the outstanding bond ratings that were reported by the ten NRSROs to the SEC, the three major CRAs accounted for 96.5 percent of the total.[6]

One other historical event is noteworthy: In the late 1960s/early 1970s the three major CRAs changed from John Moody's "investor-pays" business model to the "issuer-pays" model that prevails today. The CRAs feared that unauthorized high-speed photocopying (which was just coming into widespread use at the time) would limit their ability to expand their revenues (similar to what digital reproduction would do to the recorded music business in the early 2000s).

IV. THE HOUSING BUBBLE, THE DEBACLE, THE ROLE OF THE CRAS, AND THE DODD-FRANK RESPONSE.

Starting in the late 1990s, the U.S. economy experienced a major housing boom—which is now recognized to have been a bubble. Helping fuel the housing bubble was the technology of mortgage securitization: the pooling of hundreds (and sometimes thousands) of residential mortgages into residential mortgage-backed securities ("RMBS")—bonds—that could be sold to investors. And helping fuel the mortgage securitization process were the favorable ratings that the major CRAs assigned to these securities.[7] As is now well known, the CRAs initially gave favorable (high) ratings to hundreds of billions of dollars of these RMBS that subsequently required substantial downgrades.

The Dodd-Frank Act included important sections that applied to ratings and the NRSROs. Recognizing that the regulatory use of NRSRO ratings was an artificial enhancer of the importance of the NRSROs, and especially of the three major CRAs, the Act eliminated all references to NRSROs in federal statutes and instructed federal financial regulators to examine and, wherever possible, remove from their regulations references to NRSROs' ratings (and concomitantly find alternative ways to achieve their regulatory goals without the use of NRSRO ratings).[8] The Act also instructed the SEC to toughen its regulation of the NRSROs themselves:

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[4] For example, the SEC had never established a formal application process or formal criteria for becoming a NRSRO.

[5] In addition, by requiring annual recertification of all NRSROs, the CRARA effectively established SEC regulatory powers over the NRSROs.

[6] However, this was down from 98.8 percent of the total in 2007. Also, in one category—the ratings of insurance companies—the three major CRAs accounted for "only" 75.5 percent of the total.

[7] More specifically, the CRAs' favorable ratings were important for the sale of "private-label" RMBS—i.e., those that were not issued by Ginnie Mae, Fannie Mae, or Freddie Mac.

[8] However, the Act was silent with respect to one major category of the use of NRSROs' ratings: the prudential regulation of insurance companies by the 50 states.

specifically, to force the NRSROs to pay greater attention to their conflict-of-interest issues (e.g., as embedded in the issuer-pays business model) and to the transparency of their rating methodologies.

V. WHAT WENT WRONG?

Why did the CRAs give such favorable initial ratings to such large amounts of RMBS? Many commentators have pointed to the issuer-pays business model of the CRAs and its obvious potential conflict of interest: Issuers can “shop around” and thereby pressure each CRA for a more favorable rating.

However, just pointing to the issuer-pays model is not sufficient. *All* of the major CRAs' ratings have been issued under this model since the early 1970s. But the CRAs' ratings in their traditional areas (corporate, municipal, and sovereign debt) didn't deteriorate in the three decades that followed, and still have not deteriorated[9] in the way that the MBS ratings clearly did. Why the difference?

Let's start with how the issuer-pays model—despite the potential conflict—could be robust: A CRA's concern for its long-run reputation should serve as a counterbalance to issuers' requests for more favorable ratings, since bond investors' eventual discovery that the CRA had acceded to issuers' pressures will cause the investors to reduce or cease their trust in the reliability of that CRA's future ratings. In turn, future issuers will cease (or be more reluctant) to engage that CRA for future bond ratings. Accordingly, if the expected gains from maintaining a reputation for accuracy exceed the expected gains from acceding to issuers' requests for favoritism, the CRA will resist those pressures.

This appears to have been the case for the major CRAs' traditional corporate, municipal, and sovereign ratings business.

However, the concerns about any organization's long-run reputation can be overwhelmed by the prospects of sufficient short-run gain. And it appears that these long-run concerns were overwhelmed in the area of RMBS ratings. Strong anecdotal evidence indicates that “rating shopping” and pressures by issuers on the CRAs occurred during the 2005-2007 period; and academic statistical studies indicate that issuers did shop for favorable ratings and also that this shopping did induce more favorable ratings.

So, why did the reputation model melt down in the latter area but not the former?

For the former: The traditional bond rating areas have thousands of issuers; no single issuer represents a significant portion of the revenue of a major CRA. This makes it easier for the CRA to resist an issuer's shopping-around threats. Further, an abundance of publicly available information is available about these issuers' finances (e.g., SEC-mandated corporate disclosures, and annual budgets and related documents for municipalities and sovereigns), so that outside analysts (e.g., those fixed-income analysts at securities firms and the smaller CRAs) could readily spot and trumpet any apparent rating deviation that would unduly favor an issuer. A CRA's

[9] Instances of sluggish downward adjustments in ratings—as for Enron—are indicative of a long-standing “cultural” tendency to adjust ratings slowly, which was present in the credit rating industry long before the change to the issuer-pays business model.

awareness of this external scrutiny and its consequences would strengthen the CRA's resistance to issuers' pressures.

By contrast, the numbers of issuers/packagers of RMBS were far fewer: Approximately a dozen issuers accounted for about 80-90 percent of the RMBS that were being issued and rated. The flows of new RMBS issuances were large, and were expected to continue to be large, and the major CRAs' margins on these RMBS ratings were considerably wider than for their traditional business. Thus, the temptations to accede to RMBS issuers' requests (and the fears of the consequences of not acceding) were substantially greater.

Reinforcing this temptation was a far more opaque information setting: Although the issuer would provide to the CRA detailed "loan-level" information about the characteristics of the underlying mortgage loans for the RMBS, the general public was provided only with summary statistics (e.g., means and ranges) for those same characteristics.[10] Accordingly, any "favors" that a CRA might do for RMBS issuers would be less likely to be discovered (as compared with the CRAs' traditional ratings), which would make a CRA more likely to accede to RMBS issuers' requests.

In sum, the market characteristics of the traditional rating areas of corporate, municipal, and sovereign bonds were (and are) such that the potential conflicts of the issuer-pays model were (and are) unlikely to be converted into actual conflicts that would undermine the CRAs' long-run reputations. But the market characteristics of the newer RMBS bonds were substantially different and more conducive to a breach of that reputation-maintenance model.

VI. WHAT IS TO BE DONE?

It is easy to understand the desire by legislators and regulators to want (figuratively) to grab the major CRAs by the lapels and shout, "Do a better job!" And the portion of the Dodd-Frank Act that instructs the SEC to regulate the NRSROs more tightly reflects that desire.

"Do a better job!" is a call for better outcomes: more accurate ratings. But the SEC doesn't try to assess the accuracy of the NRSROs' ratings; indeed, the CRARA forbids the SEC from directly influencing the content of the NRSROs' ratings as well as their methodologies and their business models. Instead, the SEC's regulation has focused on "inputs:" the transparency of a NRSRO's methodology and rating results, and efforts to address any conflicts of interest. This focus on inputs rather than outputs is, at best, an indirect way of achieving the goal of improved accuracy of ratings.

Further, regulation of this sort will bear more heavily on the smaller NRSROs, since there are substantial fixed costs of compliance. This could make it harder for smaller NRSROs to compete and discourage other creditworthiness advisory firms (which tend to be small) from applying to become NRSROs. A potential irony of such regulation is that *the relative importance of the three major CRAs could increase* as a consequence of the SEC regulation.

In addition, such regulation is likely to discourage innovation: in rating methodologies, technologies, and possibly even business models. This would be true for at least three reasons:

[10] To make the setting even more opaque: The "shopping-around" by issuers focused on the fraction of a RMBS's tranches that would be rated "AAA."

First, such regulation often has difficulties in dealing with firms that have new ideas; they often don't fit the "boxes" that regulation usually creates. Second, entry is often the vehicle for innovative ideas, and entrants are often small; but, as discussed above, the SEC regulation bears relatively more heavily on smaller firms. Finally, the Dodd-Frank Act's required transparency may discourage the development of new methodologies if their development is costly but their proprietary advantage is lost because of that required transparency.

There is a better way: That way should emphasize more competition.[11] It thus has the spirit of antitrust, although direct antitrust measures aren't needed.

It starts with the other part of the Dodd-Frank Act that dealt with CRAs: the elimination of financial regulators' blind reliance on the NRSROs' ratings. This elimination would open the field to more creditworthiness advisory firms that can attract the attention of more issuers and institutional investors.[12]

In this respect, the Dodd-Frank Act was a good start but too timid. Although some regulators have made the transition, others have been tardy. The Congress needs to prod the tardy agencies to speed their efforts—and also to convince state insurance regulators that they too must cease blindly relying on the NRSROs.

Next, if regulatory reliance by financial regulators on NRSROs is eliminated, then the NRSRO category and the SEC's regulation of the NRSROs can be eliminated. Recall that the bond market is dominated by institutional investors. Professional bond managers should be able either to gather their own creditworthiness information about bonds or to be able to make informed decisions as to who is a reliable third-party provider of such information.

With regulatory reliance and the NRSRO system eliminated, *competition* among creditworthiness advisory firms would be freed in a way that surely has not been true for almost 40 years—or, arguably, almost 80 years. And, in addition to the current inventory of such firms, some of the fixed-income analysts at securities firms that have established reputations for themselves might feel more encouraged to "hang out their own shingles" and provide more competition as freestanding entities.

A more competitive environment is unlikely to lead to large changes in market shares quickly. A reputation-based market is likely to move slowly—especially since the major CRAs' reputations in their traditional ratings areas are largely intact. Nevertheless, it would be an important start.

Finally, the issue of the ratings of RMBS does deserve more attention: Following (and because of) the debacle of 2007-2008, "private-label" RMBS issuances have been largely absent from the bond market. If and when such RMBS do re-enter the market, the structural features that encouraged the meltdown of the reputation model for the CRAs—notably, the fewness of

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[11] Some commentators have noted that more CRA competitors would give issuers more opportunities to shop around for favorable ratings. However, this negative view overlooks the positive role of competition, including entry, in encouraging innovation. Also, in the more open context that is discussed below, professional bond managers and prudential regulators can be expected to be more wary of the shopping-around phenomenon.

[12] Financial regulators will still want to ensure that their regulated institutions can justify their sources of information and aren't relying on flim-flam entities.

issuers, and the opaqueness of information—require some attention. With respect to the former, professional bond managers (after the debacle) will surely be more wary of CRAs that employ the issuer-pays business model for these types of bonds; similarly, prudential regulators should definitely be reminding their financial institutions of the potential dangers.

With respect to the opaqueness of RMBS information, the SEC partially addressed the issue in 2009 by requiring that any NRSRO that has been hired for a RMBS rating must make the detailed loan-level information available to any other NRSRO that requests it. However, the SEC was too timid and placed too many restrictions on this process. Instead, the SEC should mandate that all such information should be available to the general public and not just to a category of CRAs. By doing so, the SEC would bring RMBS information disclosures into harmony with the SEC's general regime of widespread dissemination of material information for publicly traded companies. And this would add more potential critics who could "look over the shoulders" of any RMBS raters, which should help reinforce the reputation-maintenance model.

VII. CONCLUSION.

The question of how to deal with the major credit rating agencies is important and complex—and is not going away soon. Neither of the "easy" answers—"more regulation" or "no regulation"—is satisfactory.

Instead, more—and more effective—competition, along with less (but better focused) regulation would provide a better policy route.

COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
January 2014 (2)

Looking at Credit-Rating Agencies Through a *Leegin* Lens

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Looking at Credit-Rating Agencies Through a *Leegin* Lens

Mark R. Patterson [1]

I. INTRODUCTION

In a 2007 memorandum, Raymond McDaniel, the Chairman and CEO of Moody's Corp., described competition among credit-rating agencies in a way that should give antitrust lawyers pause:

> Ideally, competition would be primarily on the basis of ratings quality, with a second component of price and a third component of service. . . . The real problem is not that the market . . . underweights ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.[2]

The basic claim here—that there are fundamental problems with competition in the credit-rating business if we care about ratings accuracy—is supported by financial research. Bo Becker and Todd Milbourn have provided evidence that the entry of Fitch as a third credit-rating agency in the market actually led to less accurate ratings.[3] More specifically, increases in Fitch's market share were associated with decreases in rating quality, including both higher ratings and less correlation between ratings and actual bond yields.

Of course, this is a failure of competition only if we view the goal of competition as producing accurate ratings. If the goal of competition among credit-rating agencies is to make them serve the needs of their customers, competition appears to be working. The customers who pay for ratings are the issuers of securities and, as McDaniel describes above, those issuers want higher ratings, not more accurate ratings.

II. VIEWING THE CREDIT-RATING AGENCY MARKET THROUGH AN ANTITRUST LENS

My purpose in this essay is to suggest that the mismatch between competition and ratings accuracy is less surprising if we view the credit-rating agency market through a different lens than is typically used. My suggestion begins from the underlying structure of the credit-rating market. Although issuers pay agencies for ratings, the underlying transaction that motivates the production of ratings is the sale of securities by issuers to purchasers. In that transaction, the

[1] Professor of Law, Fordham University School of Law. I benefited from helpful comments by Harry First, Richard Squire, and Chris Sagers, none of whom should be taken to agree with the views expressed here.

[2] Memorandum from Raymond McDaniel to Raymond McDaniel, Oct. 21, 2007, *available at* http://oversight-archive.waxman.house.gov/documents/20081022111050.pdf.

[3] Bo Becker& Todd Milbourn, *Reputation and competition: evidence from the credit-rating industry*, Harv. Bus. Sch. Working Paper, 09-051 (Feb. 12, 2009).

credit-rating agencies stand between the sellers and buyers as information intermediaries.[4] This structure resembles that of other intermediary arrangements, like financial auditing or certifications like those of Underwriters Laboratories, and it shares at least some of the characteristics of two-sided markets. However, there is no accepted antitrust analysis either for information intermediaries or, despite a burgeoning economic literature, for two-sided markets.[5]

Nevertheless, this sort of market structure, involving a seller of a good, an intermediate provider of information about that good, and buyers, is present in another context that is a frequent subject of antitrust scrutiny: vertical distribution restraints. There are of course differences in the two contexts, but there are also significant similarities, which makes looking at credit-rating agencies as part of a vertical distribution system a worthwhile exercise.

A. Structural Similarities with RPM and Other Distribution Restraints

The typical dealer in a vertical distribution case does not, of course, provide *only* information. It typically delivers the actual products that are the subject of the information as well. But we can separate the two functions and consider them individually. Some of a dealer's margin serves to compensate it for its actual distribution services (the cost of maintaining inventory, delivery personnel, etc.), some perhaps for service costs, and some for promotional, or informational, services. In securities markets, the distribution services are performed by underwriters or banks, which also perform some of the promotional services. But the credit-rating agencies' services can be viewed as promotional, too, just as we view the informational services of dealers in typical product distribution chains.

The arguments about why credit-rating agencies may provide too-favorable ratings generally focus on the payment structure in the credit-rating agency market. Most credit-rating agencies, and all of the three dominant ones, are paid for their services by the issuers of the products they are rating. In that, too, they resemble dealers in production distribution chains. Those dealers are sometimes compensated directly by the producers of the products they sell, but even when they are not, the justification for resale-price maintenance ("RPM") and other distribution restraints imposed by producers is that those restraints provide dealers with sufficient margins to promote the manufacturers' products. That is, the distribution restraints are a means of compensating dealers for promotional services.

One final difference in the two markets is that RPM and other vertical restraints are often specifically included in the contract between the producer and dealer, making the application of Sherman Act § 1 straightforward. With credit-rating agencies, there is no comparable contractual "restraint of trade" beyond the payment from the issuer to the credit-rating agency. That may make § 1 inapplicable, but the point here is not so much to suggest a legal treatment for credit-rating agencies as to suggest an analogy to help understand the market.

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[4] An excellent review of credit-rating agencies, focusing specifically on this intermediary function, is Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 ADMIN. L. REV. 557 (2009).

[5] *Cf.* Pola Karolczyk, *Product Certification – the next big standard-setting debate*, Kluwer Competition Law Blog (Mar. 14, 2013) *available at* http://kluwercompetitionlawblog.com/2013/03/14/product-certification-the-next-big-standard-setting-debate/.

The effects of RPM, of course, need not be imposed through an agreement, either. Those effects are often produced unilaterally, avoiding § 1 as permitted by *United States v. Colgate Co.*,[6] through announcements of the pricing policy and subsequent unilateral refusals to sell to dealers that do not follow it. Somewhat similarly, securities issuers sometimes engage in "rating shopping" by going from one credit-rating agency to another until the desired rating is obtained.[7] The key point is that the incentives in both contexts are similar, so the analogy may provide some useful insight into both arrangements.

B. Do Similar Structures Imply Similar Anticompetitive Harm?

One might object that even if the structures of the two markets are similar, the potential anticompetitive harms are not. The harm of RPM is generally viewed as higher prices, but for credit-rating agencies the harm is inaccurate ratings. The harm of RPM is not high prices in some absolute sense, though, but high prices in comparison to the value received or, equivalently, services of lower quality than the prices justify.

Similarly, inaccurate credit ratings are low-quality products that do not justify the prices that investors pay for them, indirectly, though securities prices. In either case, harm can be caused by the provision of inaccurate information, and, in either case, the reason is that the seller, whether the producer of a good or the issuer of a security, may be more interested in selling than informing.

One of the more thorough expositions of this issue in the distribution context has been presented by Warren Grimes, who describes how providing dealers with a high margin can induce them to provide misleading information to consumers in order to induce sales. His summary could equally well be applied to credit-rating agencies, substituting "security" for "brand," "issuer" for "producer," and "credit-rating agency" for "dealer":

> [B]rand promotion can be anticompetitive if it leads a consumer to make less competitive choices than the purchaser would otherwise make. . . .
>
> . . . Consumers can grasp the self-interest that motivates producer brand promotion. In dealer brand promotion, self-interest can be hidden--consumers may be unaware that a dealer benefits by selling one brand over another. Moreover, although both producers and dealers may occasionally dispense inaccurate information, dealer promotion abuses are often more difficult to monitor and control.[8]

If we accept the fundamental similarity of these two markets, what are the implications for antitrust treatment of credit-rating agencies? It is currently unclear what antitrust approach, if any, should apply to credit-rating agencies.[9] Although it is unlikely that we would apply the law of distribution restraints, even if we could bring credit-rating agency arrangements under § 1—

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[6] 250 U.S. 300 (1919).

[7] *See* Rosa M. Abrantes-Metz, *Is There Misdiagnosis in the Market for Credit Ratings*? 11(2) CPI ANTITRUST CHRON., (Nov. 2013).

[8] Warren S. Grimes, *Spiff, Polish, and Consumer Demand Quality: Vertical Price Restraints Revisited*, 80 CAL. L. REV. 815, 818 (1992).

[9] *See* Nicolas Petit & Norman Neyrinck, *Credit Rating Agencies and Competition Law*, 8(2) CPI ANTITRUST CHRON., (Aug. 2011).

perhaps by viewing the contractual payment by issuers to credit-rating agencies as sufficient to establish a contractual restraint of trade—it is still worth considering the application of distribution law, simply as a thought experiment.

C. Using Leegin to Assess Credit-rating Agencies

As suggested above, the payment arrangements for credit-rating agencies would seem to make RPM, rather than nonprice restraints, the closer distribution analogy. In the Supreme Court's latest word on RPM, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*,[10] the Court set out several pro-competitive justifications for RPM and several market characteristics that could give rise to concern.

The pro-competitive justifications center on free-riding. The idea, as is well known, is that dealers will not provide services or promotional efforts if other dealers can undercut their prices, making it impossible to profit from the provision of the services and promotion. However, this justification is not present with credit-rating agencies because they receive payment directly from issuers, not from sales of the securities. In the same way, courts in distribution cases have held that the free-riding rationale does not apply where dealers are paid directly by producers for their services.[11]

With respect to what the *Leegin* Court called "economic dangers," the Court listed three factors that could create concern: (i) the number of producers using the challenged practice, (ii) whether the practice originated with dealers rather than the producer, and (iii) whether the producer or dealer had market power.

1. Overall Market Coverage

To determine whether the practice is widespread in the market, we need to consider what "the practice" is. The most likely candidate seems to be the issuer-pays model,[12] and that model constitutes almost 100 percent of the market. Thus, to the extent that the current model injures purchasers of securities, they will find it difficult to avoid it. Although there are a few subscriber-pays credit-rating agencies, the dominance of Moody's, S&P, and Fitch is generally accepted, and they all use the issuer-pays model. This *Leegin* factor thus provides reason for concern.

2. Source of Practice

Furthermore, the switch from a subscriber-pays model to an issuer-pays one in the 1970s was arguably prompted by the credit-rating agencies, which *Leegin* suggests should raise concerns. But the reason usually offered for the change is the improvement in photocopying technology that allowed a rating report, upon being issued to a paying subscriber, to be copied for other potential subscribers. In other words, the goal was not to exploit the credit-rating agencies' power, which was the concern of *Leegin*, but simply to ensure compensation for rating services. Therefore, this factor does not seem significant here.

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[10] 551 U.S. 877 (2007)

[11] *See* Toys "R" Us, Inc. v. Federal Trade Commission, 221 F.3d 928 (7th Cir. 2000); General Leaseways, Inc. v. National Truck Leasing Association, 744 F.28 588 (7th Cir. 1984).

[12] Rating shopping would be another possibility, but even if no shopping occurred in a particular instance, the threat of such shopping would likely be present, at least unless there are issuers that have a reputation for never engaging in it.

3. Market Power

The question of the market power of the dealers and producers—or credit-rating agencies and issuers—is the most interesting one. The "big three" credit-rating agencies collectively have approximately a 95 percent market share, and the share of the two larger ones, Moody's and S&P, is about 80 percent. These shares are even more significant because an issuer will often obtain ratings from two agencies. Although there is no formal obstacle to an issuer using one of the smaller agencies,[13] including a subscriber-pays agency, the share of the big three appears not to be eroding, even as the number of smaller agencies has increased.

Turning to consider the power of issuers, the securities market is probably one of the least concentrated markets in existence. There are thousands of securities, and they all provide the same thing, financial returns, so there is in one sense little product differentiation. In another sense, though, the issuance of some forms of securities may actually be quite concentrated. Rosa Abrantes-Metz has argued in this journal that "[t]he structured finance market is characterized by a few large financial institutions who issue these securities and who have the market power to possibly influence credit-rating agencies to at least adopt more liberal analytics—if not outright compromise them."[14] The power she is suggesting is not, however, power over purchasers of securities but power over credit-rating agencies. *Leegin*, in contrast, was referring to power over the ultimate buyers, because without power over them, the ability of the producer and the intermediate dealer to exploit those buyers would be limited.

The power, if any, of a securities issuer or a credit-rating agency over securities purchasers does not likely originate in market share of the security or the agency. Instead, the likely source of power for securities issuers is the difficulty for potential purchasers of evaluating the quality of the security or its rating. It is this difficulty of evaluating securities that has created the demand for credit-rating agencies, but the evaluation of ratings quality poses the same problems as does the evaluation of the securities themselves. As Becker and Milbourn say, "[t]he quality of individual ratings is hard to assess for the investors and regulators who rely on them."[15] And if buyers cannot assess the quality of the goods they are buying, sellers may be able to price them supracompetitively, *i.e.*, exercise market power.[16]

Although this may not be the sort of market power that the *Leegin* Court had in mind (though notably it did not refer to market share), it is exactly the sort of power that could cause competitive problems in this context. Market power, after all, turns on the ability and incentives of competitors to prevent anticompetitive conduct. Credit-rating agencies have not had a history of pointing out flaws in their competitors' ratings and, even if they did, it is not clear that

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[13] *But see* OECD, Competition and Credit Rating Agencies 6, DAF/COMP(2010)29, Oct. 5, 2010, http://www.oecd.org/regreform/sectors/46825342.pdf (describing the credit-rating agency market, somewhat implausibly, as a natural oligopoly).

[14] Abrantes-Metz, *supra* note 7.

[15] Becker & Milbourn, *supra* note 3, at 1.

[16] If buyers are aware of this problem, then perhaps they will discount all quality ratings, and the sellers of high-quality products will not be able to charge the price that their products are worth. *See* George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). Indeed, one of Akerlof's examples is credit markets. The "lemons problem" has not, however, eliminated securities markets.

consumers would be able to judge between the competing claims, given their lack of knowledge about rating methodologies.

Competing issuers are also unlikely to effectively counter inaccurate information about another issuer's security, for at least two reasons. First, they may face the same informational problems as do potential purchasers, in that they are not likely to have access to private financial information about their competitor. Second, the competing issuers best positioned to assess securities are those offering similar securities and, to the extent that any creditworthiness problems arise not from issuer-specific information but from systematic issues, the competing issuers' pricing would suffer from emphasis on that information as well. Indeed, this problem is greater here than in most, though not all,[17] product markets, because producers of other sorts of products will often be quite willing to point out flaws in the products of their competitors.

The upshot, then, is that the market for credit-rating agencies, viewed by analogy to vertical distribution restraints, appears to present the competitive dangers *Leegin* saw in such restraints without offering the usual competitive benefits. That is not to say, of course, that those dangers cannot be overcome. Reputation effects and repeated purchases in reliance on ratings surely provide some constraints. But as the quotation from Raymond McDaniel at the beginning of this piece shows, these constraints may be very attenuated, or may even exacerbate the problem. Not all consumers, and maybe not even the majority of consumers, in this market have the goal of receiving high-quality information. That is true for distribution restraints as well as for the credit-rating market, but only the latter has societal implications important enough to have created widespread calls for a remedy.

III. CONCLUSION

It is not clear, though, what remedies would solve this problem, at least through antitrust law. In the credit-rating context, in contrast to typical distribution restraints, it may not be feasible to prohibit the "restraint," even if the restraint is accepted to be the issuer-pays model.

And, as described above, it is not clear that greater competition among credit-rating agencies would lessen the problem, just as it is not clear that a greater number of dealers would provide more beneficial promotional services in the usual distribution context. The fundamental problem is that when information affects purchasing decisions, sellers will always have incentives to distort the information purchasers receive, and it may often be possible to persuade information intermediaries to go along.[18]

Fortunately, the goal of this essay has not been to solve these problems but simply to highlight them by analogy to a familiar antitrust issue. The informational aspects of the credit-rating market are not fully captured by looking only at the transaction in which the services of the rating agencies are purchased by issuers. The same is true for other similar markets, yet many

[17] *Cf.* Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451, 474 (1992) ("Even if competitors had the relevant information, it is not clear that their interests would be advanced by providing such information to consumers.").

[18] For a somewhat polemical view of this danger, *see* Mark R. Patterson, *On the Impossibility of Information Intermediaries*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276968 (July 2001).

cases involving information products, like the recent Bazaarvoice merger challenge,[19] focus only on that one side of the market.

Instead, it is important when assessing information intermediaries to consider the overall structure of the markets in which information is provided for the ultimate user of the information. It is important also to recognize that we might not find it satisfactory for those who pay for information to receive the information they want, when society would benefit from more accurate or useful information. In the end, information presents particular problems for competition, and antitrust law needs to develop new analytical techniques for these problems.

[19] The Department of Justice recent successfully challenged the merger of two providers of online "ratings and reviews platforms." The case focused almost exclusively on the market in which the two companies provide their platforms to commercial websites, *see* Memorandum Opinion, United States v. Bazaarvoice, Inc., No. 13-cv-00133 (filed Jan. 8, 2014), and said little about whether there might be effects on the information provided to consumers. Just as with credit-rating agencies, one wonders if there might be incentives for the platform providers to provide products that benefit their website customers at the expense of consumers. (For example, eBay used to make it difficult to read negative reviews on its website.) And one wonders, as with credit-rating agencies, whether those incentives would be greater or less with more competition among the platform providers. *Cf.* Complaint, United States v. Bazaarvoice, Inc., No. 13-cv-00133-WHO (filed Jan. 10, 2013), at ¶¶ 50-54 ("Bazaaarvoice and PowerReviews engaged in 'feature driven one-upmanship,' which drove both firms to innovate and develop new PRR platform features.").

CPI COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle

January 2014 (2)

Reforming Credit Ratings Agencies: More Competition, Less Regulation or Both? A Proposal for Moving Forward

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Reforming Credit Ratings Agencies: More Competition, Less Regulation or Both? A Proposal for Moving Forward

R. Shyam Khemani & Ritha Khemani[1]

I. INTRODUCTION

While the root causes of various financial crises during the past two decades have differed, there have been recurrent questions regarding the possible role played by the Credit Ratings Agencies ("CRAs"). Among the concerns that have been raised are: the highly concentrated nature of the credit rating industry, with the leading three CRAs (viz., Moody's, S&P, and Fitch) accounting for the bulk of the global rating services market; their oligopolistic interdependent and possibly tacit collusive behavior, suggesting lack of effective competition; limited diversity and choice among "globalized" rating agencies; and regulatory and other barriers to entry that entrench the incumbent CRAs. In addition, the failure of the CRAs to properly rate sovereign debt during the Asian financial crisis or, more recently, corporate debt in the case of the Lehman Bros. bankruptcy, and other lapses point to major errors committed by the CRAs.

These errors have led to increased calls for reform and change—such as promoting greater competition, and/or revising the regulations governing CRAs, or even creating new bodies that could perform the function of CRAs—though these calls tend to wane when the financial crisis is over and economic recovery starts taking place. However, it is precisely during the post-crisis period—such as now—that stocktaking and assessment of CRAs should take place, and alternative policies and instruments be explored.

In the ensuing discussion, some of these issues are discussed briefly and a proposal is offered for dealing with the concerns that have been raised. Cognizant of the systemic impact that changes to the current process of credit ratings could have on financial markets, any new approach will need to be put adopted after extensive discussions, consultations, and cooperation with relevant participants in both the private and public sectors. The resulting proposals for change may also have to be gradually phased in.

II. IMPORTANCE OF CRAs

Essentially, CRAs provide information on the creditworthiness of debt issuers and play a critical role in the lending and borrowing process. They evaluate and rate corporate and sovereign debt issues. Asymmetry of information between the lender (who generally has less information about the borrower) and the borrower (who may have incentives for not disclosing all its liabilities/financial obligations) is a major gap in lending relationships. Lenders and investors need information as to whether the borrower has the ability and willingness to pay. While specialist lenders can gather data and information, and develop their own assessments,

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this would be costly, especially for the smaller non-specialist lenders. The ratings provided by CRAs reduce the inherent problems of asymmetric information.

However, what makes the lenders and investors trust the rating of the CRA? Analysts, and indeed the industry itself, have strongly argued that this is importantly based on CRAs' reputation and credibility. Since building reputation and credibility takes time, it poses as a barrier to entry which, together with other factors, have resulted in a highly concentrated industry structure, with the potential for anticompetitive behavior.

III. HIGH CONCENTRATION AS A CONCERN

A report by the Bank for International Settlements ("BIS"), published in 2000, mentions about 150 agencies worldwide. This includes a relatively large number of specialized smaller firms. However, only three U.S. based firms—Moody's, Standard & Poor's, ("S&P") and Fitch—are the principal "global" rating agencies, and tend to dominate the industry.

There are additional credit rating firms outside the United States, but these three U.S. firms have substantial presence in Europe through branch offices, and have significant presence and provide extensive ratings in other continents as well.

IV. DOES THE FEWNESS OF CRAs MATTER AND/OR ADVERSELY IMPACT ON BUSINESS CONDUCT AND PERFORMANCE?

Explanations that have been offered as to why there are such few firms have not been entirely satisfactory. Outside the United States this may be the case because of the relative small size and under-developed nature of the bond market. But rating firms are relatively few in the United States as well, where the securities market is well developed, large, and has been growing.

It is indeed somewhat puzzling that there are a large number of firms that offer assessments about stocks and the associated risk and investment potential, but few firms do so with respect to debt. Analysts have wondered whether this is because there are regulations requiring the offer, sale, and purchase of such securities. Due to prudential regulation requirements, various institutional investors such as pension funds, banks, et al., are required to hold financial products that are rated—which creates a built-in demand for the services of CRAs.

As the industry has developed, the practice of an "issuers-pay" model for ratings has evolved and gained wide acceptance as against an "investors-pay" model that previously existed. Typically, debt issuers will solicit and pay for having at least two ratings in order to provide investors' confidence on their creditworthiness. There are also some CRAs that conduct unsolicited ratings based on publicly available information (mainly relating to sovereign debt) but these account for a small percentage of the total.

The CRAs themselves strongly argue that it takes time to build experience and reputation in these markets and that this can be a significant barrier to entry. It apparently took the third ranking CRA (Fitch) over a decade to establish itself.

V. CAN INSTRUMENTS OF COMPETITION LAW AND POLICY BE APPLIED TO INCREASE COMPETITION?

Both the fewness of firms in the industry and the industry's entry barriers have raised questions relating to the possible use of market power to engage in anticompetitive practices such

as collusive behavior, monopolization, or abuse of market dominance. Should there be tangible evidence of CRAs engaging in fixing fees charged to issuers, allocating markets and/or customers, or abusing their dominant position in the market, then CRAs would certainly run afoul of most competition laws. The United States and the European Union both have a strong record of competition law enforcement that would pose as significant deterrent to such business conduct.

Further, while in theory the largest CRAs could be in a "conflict of interest position" whereby borrowers willing to pay higher fees would obtain a higher rating, there have been no substantiated cases that this has occurred. The reputational damage that such behavior would cause would be irreparable, and provide competitive advantage to other rating firms.

There are of course other complexities entailed in trying to construct a case against CRAs' possible anticompetitive behavior, but these largely fail. To mention a few: (i) high concentration and inter-dependent or parallel behavior does not constitute a violation of competition law; (ii) circumstantial evidence needs to be complemented with other "plus" factors/evidence; (iii) the relevant market needs to be delineated—which could prove difficult given the plethora of financial data and publications that can be accessed by investors to gauge creditworthiness; (iv) competition between CRAs is based not only on price but also on quality, accuracy, and timeliness of the relevant information, among other such determinants; and (v) while CRAs have committed errors in their ratings, these do not constitute infractions of competition law—though they may arise due to low level of intensity of competition and choice of rating agencies.

In addition to the forgoing, there is variation in the ratings conducted by the CRAs. While there is similarity in the ratings of the largest (first tier) corporations and countries, this is not the case with medium and small firms, and across regions. And, regarding global concentration, among the leading three CRAs, one of them may be more present in Latin America while the other in Asia.

In summary, in the literature on CRAs, concerns regarding the state of competition have been raised, but at this stage these are primarily conjectures and do not provide a basis for investigating the industry. If, indeed, a significant anticompetitive arrangement or conduct is unearthed, existing competition laws in most jurisdictions provide a sufficient arsenal of instruments to deal with it.

VI. ARE REGULATORY PRACTICES THE CULPRIT?

Meeting mandatory regulatory requirements usually imposes costs that can serve as a barrier to entry. However, the industry is in large part still self-regulated. The International Organization of Security Commissions ("IOSC") has a set of voluntary principles or conduct rules for the CRAs to adopt (which were strengthened after the financial crises). These basically spell out requirements with respect to public disclosure, avoidance of conflicts of interest, integrity of the rating process, and the like. The IOSC, however, has no enforcement mechanism.

In the United States, the SEC has an oversight role by its process of recognizing and designating certain CRAs as Nationally Recognized Statistical Rating Organizations ("NRSROs") whose ratings can be used for regulatory compliance purposes. The Credit Rating Act of 2006 also gave it powers to conduct on-site inspections and to take actions if there are violations.

Essentially the enhancements required greater industry transparency and gave SEC powers for dealing with conflicts of interest and abusive practices.

EU regulations have similarities with those of the United States. They require the CRAs operating in the European Union to be in full compliance of the IOSCO Code in their codes of conduct. EU regulation is also based on some directives that deal with market abuse ("MAD") and a directive on the capital requirements ("CRD") that firms have to meet to be recognized as CRAs or ECAIs ("External Credit Assessment Institutions").

It has been argued that the SEC criterion for recognizing NRSROs was not sufficiently transparent and that the time lag for gaining accreditation was too long, increasing the costs of entry. Nevertheless, the number of recognized firms, albeit slowly and by a small number, has increased since the SEC introduced the NRSRO requirements

While the regulatory requirements on firms do not seem to have increased significantly; nor can it be said they have substantially increased compliance costs, the regulatory *use* of ratings has expanded via several channels. Demand for ratings has increased as the securities market has expanded. Pension and other institutions regularly require ratings for investment decisions. Holders of commercial paper such as money market funds use NRSRO ratings as benchmarks to establishing standards and, indeed, even the U.S. government increased its reliance on CRA ratings in giving out loans under the latest financial crisis. There has also been an increased demand for ratings under the rules of the Basel Committee on Banking and Supervision ("BCBS") ,which attempts to align capital requirements to the bank's risk of economic loss. Banks also use ratings assigned by recognized CRAs in determining credit risk weights for their institutional credit exposures.

It is puzzling, therefore, that in spite of both higher demand and little evidence that there are higher costs of entry due to regulation, the number of firms has not significantly increased. In fact, some analysts argue that this is because reputation (which takes time to build) is critical for gaining acceptance. The additional demand for rating services has merely entrenched the dominant position of existing firms. All in all, it is clear that there may be no easy solution to foster more competition and instill competitive behavior through changes in regulations. Moreover, it is important to minimize interventionist policies that could reduce innovation and efficiency in financial markets.

VII. A PROPOSAL FOR CHANGE: THE NEED TO TREAD EASY AND ADOPT A MEASURED PACE.

There is no dearth of reform measures that have been suggested with respect to CRAs. Except for the recommendation that calls for more competition, these proposals have generally tended to work on existing structures. The proposals suggested below have potential for changing the existing structure. They would address the issues identified above: 1) the need to inject competition, 2) the need to address the "problem" that, in order to be effective, there is a need for any new CRA to establish a reputation quickly, and 3) the need to minimize any interventionist regulatory policy that could impinge negatively on innovation and efficiency in the financial sector.

VIII. A ROLE FOR THE IMF?

The main thrust of the proposal is for the IMF to play a greater role in the credit rating process *as it relates to sovereign debt.* A weaker and a stronger modality for the IMF's role are put forward.

A. The Weaker Modality Form

T*he weaker modality form* would give the IMF an oversight role on CRAs world-wide and assess their performance. At the present time, there is an information gap for investors in that they have little solid information to form judgments on the performance of the larger CRAs, let alone the smaller ones. A report on CRAs worldwide, perhaps on an annual or bi-annual basis (with timely updates), applying clear and consistent assessments (or ratings) that could be globally compared across CRAs, would provide useful information to investors on their performance.

Several positive outcomes could ensue which would reduce the barriers to entry. Filling the information gap, i.e. lack of solid assessments of the CRAs themselves, could reduce the time needed for new entrants or facilitate existing smaller CRAs to establish reputation and credibility quickly. A "shout out" of clear and well analyzed credit rating reports by smaller firms, and noted as such in an IMF report, has the potential of changing market shares and market concentration by encouraging new entry, thereby facilitating smaller firms recognized in the report to grow and gain market share. It could also be a trigger for a re-emergence of investor-pay models, which has been suggested in the literature as being preferable to the user pay models that are currently the norm. In addition, the proposal would address the question that has been asked with respect to CRAs: Who is rating the rater?

An extension of this modality could be to include the suggestion in current literature for the establishment of a centralized clearing platform for credit ratings. It has been argued that there is a "free rider" problem in the theoretically preferred investor-pay models (because of photocopying etc.) which permits non-paying firms to freely obtain information on ratings, and that a clearing platform for ratings would solve this problem. In this model the issuer would be charged a flat fee for rating and the platform would choose one or more (to overcome the problem of shopping for ratings) CRAs to issue the rating. In this model as well, CRAs would continue to operate in the sovereign debt market and compete with the IMF. Such a platform could be housed in the IMF. The selection criteria for the CRAs and other details to provide the ratings would need to be worked out.

B. The Stronger Modality Form

A stronger modality would bring the IMF more directly into the rating process. This role would be limited to sovereign debt where the IMF has considerable expertise. It would inject competition in one of the markets in which CRAs operate. The CRAs would operate without the IMF exclusively in the corporate, state, and local government level ratings.

Much of the needed infrastructure for this new role is already in place at the IMF. The IMF does regular assessments that evaluate the economic and financial policies of the countries (Article IV Reports), and conducts in-depth surveillance of the financial sector ("FSAPs") in most of its member countries. It also undertakes an assessment of debt sustainability of external

and domestic debt ("DSAs") of the member countries. The ability of the country to meet its debt obligations under current policies (and alternate policies, as in the shock scenarios) is an integral part of the debt sustainability analysis ("DSA").

Some refinements and minor changes would be needed to the assessments to perform the role filled by CRAs. One of the benefits of the CRA rating is that it provides an easy metric to compare country risk. Such a metric will need to be developed by the IMF and the criteria made transparent.

This role would inject competition quickly in the sector, as there would be (hopefully) less of a need for the new entrant (the IMF) to establish reputation. Indeed, the competition could be mutually useful and trigger the need for sharper analysis and accountability at the IMF, and also by the CRAs.

The proposal is not without its own set of caveats. It is not clear that the members of the IMF would support this role in light of conflict of interest concerns. As well, the IMF may be thrust into forming some political assessments, as a credit rating in principle looks at both the ability and willingness of the country to meet its debt obligations. Pricing of the IMF rating would also be problematic.

C. Other Reforms Needed As Well

Ideally, other reforms not related to an IMF role would need to go hand-in-hand with this proposal:

- Reducing the regulatory role of credit ratings would be desirable in order to reduce the risk that credit ratings of existing firms become entrenched.
- The time taken to obtain recognition from the SEC as a NRSRO could be capped.
- It would be ideal if one could avoid interventionist measures such as introduction of state controlled CRAs, and instead instill more competition. Such an approach will ultimately reinforce self-regulation by the CRA industry and avoid the need for imposing any regulatory burden.

IX. CONCLUSION

The credit rating industry plays an integral and important role in the financial intermediation process. The securitization process is increasingly global and there is need for global oversight. This needs to be least interventionist from the perspective of not inhibiting innovation and efficiency. A market-driven framework underpinned by greater competition would be ideal. But entry into the sector is difficult given the time-period needed for building reputation and credibility to operate effectively in the market.

This proposal aims to inject competition by injecting a new player viz., the IMF, which has the expertise, reputation, and other advantages to perform this role quickly. There are many refinements that could be suggested but the main objective is to get serious discussion started, as the best time to reform to sector is when the markets are relatively calm.

COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
January 2014 (2)

Competition Between Credit Rating Agencies: A Brazilian Point of View

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Competition Between Credit Rating Agencies: A Brazilian Point of View

Claudio Ribeiro de Lucinda[1]

I. INTRODUCTION

One of the most important issues in finance and, more specifically, in corporate finance, is the informational problems that plague financial contracting relationships—what information does each party need to know. A sizeable part of the literature on this topic concerns possible mechanisms developed to face these problems—including the best candidates to manage this information, as well as disclosure requirements, different incentive structures, and incentives for information gathering.

It is logical that comparative advantages in collecting information should lead to the emergence of institutions specialized in collecting information on corporate solvency, which then distribute this information in a way easily understood by prospective investors. Among the most important players in this arena, at least in developed financial markets, are the credit rating agencies—institutions that have, as their main objectives, to evaluate the capacity of different debtors to repay funds and provide this information to prospective lenders.

However, in both developed and developing markets, the current industry structure for credit rating agencies is more the result of the interplay of market forces and regulatory fiat than one naturally derived from comparative advantages. This interplay also drives the nature of competition between such entities. The present article provides an example of this thesis, by focusing on the competition between credit rating agencies in Brazil, and new regulations regarding these institutions.

II. CREDIT RATINGS AGENCIES IN BRAZIL

By contrast with the United States, where credit rating agencies were already strong in the early twentieth century, credit rating agencies only became important in Brazil in the nineties. The first important operation in which rating agencies were involved was in 1994, when the Brazilian rating agency SR Rating issued a rating for a structured operation involving receivables from Grupo Mesbla.

In the following year, a second domestic rating agency, Atlantic Capital, started its activities, focusing on the banking market. Only in 1996 did the international rating agencies began to enter the Brazilian market, with the association of Duff & Phelps and SR Ratings. In 1997 Standard & Poor's and the French IBCA also entered.

The next phase in the market's evolution began in 2003, with the acquisition of Atlantic Rating by Fitch Ratings. At this time, for merger reviews, revenue-based market shares broke

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down as follows: 20 percent to Fitch Brasil (resulting from the merger of Atlantic Rating and Fitch), 62.74 percent to Standard & Poor's, 9.78% to Moody's, and 3.12% to SR Rating. Since then, the largest market shares have been held by the U.S. rating companies.

Currently, the active companies in this market are the three major international companies—S&P, Fitch, and Moody's, as well as four domestic ones—SR Rating, LF Rating, Austin, and the recently created Liberum. LF Rating was founded in 2002, and Austin dates from the nineties.

To date, the industry has faced only one credibility problem, with the failure of the Santos Bank in 2004. Santos had a policy to hire only those rating agencies that gave positive ratings to its securities and over-all financial solvency. Any rating company that gave a negative rating to the bank had its relationship with the institution terminated. As a result, only two months before Santos Bank failure, Austin Rating issued a rating of "A" to Santos, stating the bank was solid and low risk. This problem prompted some discussions on the quality of the ratings issued in Brazil, but no regulatory action was taken until 2012.

III. REGULATIONS AND REQUIREMENTS FOR RATINGS

The Brazilian case is especially interesting as far as regulations are concerned, especially concerning requirements for ratings:

- Ratings are mandatory for securitization operations, especially those involving agricultural receivables and those structured as FIDC.[2]
- The Brazilian Central Bank, on the other hand, does not use ratings in determining prudential regulation guidelines for the domestic banking industry, but relies on each bank's own risk assessment for determining regulatory capital requirements. On the other hand, the same Brazilian Central Bank does rely on foreign ratings when choosing foreign assets and financial institutions.
- The Brazilian pension fund regulator requires that all pension funds (public and private) be required to take into account ratings in assessing their portfolio risks. Public pension funds are also required to invest a share of their portfolio in rated securities.
- As for the insurance market, the reinsurance companies have to have a rating of their solvency, in accordance to the guidelines of the Brazilian Insurance Regulator ("SUSEP").
- Regarding commercial relationships between rating agencies and their customers, requirements seem to conform with what is observed in other markets: the issuer contacts the rating agencies to ask for a grade concerning its ability to honor its commitments. The agencies can also issue unsolicited ratings, which are usually based on publicly available information. There are no exclusivity requirements—that is, companies are not required to use ratings from only one agency, and it is common for companies to ask for ratings from more than one agency. Solicited ratings can be made public or not, by agreement

[2] FIDC – In Portuguese, *Fundo de Investimento em Direitos Creditórios* – loosely translated as Investment Fund in Creditors' Rights. The FIDC funds itself by issuing bonds whose returns are related to the underlying assets.

between the rating agency and its customer. Major customers are banks, investment companies, asset management companies, as well as the issuers mentioned above.

Even though these requirements have created a sizeable demand for ratings, until there was no formal regulation on which companies were allowed to issue those ratings. That is, until 2012 the major barrier to entry was the reputational capital required to attract customers.

IV. A NEW FOCUS ON THE RATING AGENCIES

Instruction 521 of the Brazilian Securities and Exchange Regulator (*Comissão de Valores Mobiliarios* in Portuguese) has greatly changed the barriers to entry in this market, and therefore strongly affected the players. This instruction requires all rating agencies to be registered with the Brazilian regulator. Foreign rating agencies are also required to be registered with their home country regulators, provided there is a bilateral agreement with the Brazilian regulator or their home country is signatory of the multilateral memorandum of agreement of IOSCO. Those who do not comply with this regulation are subject to a daily fine of 500BRL.

Besides authorizing the operation of rating companies in Brazil, the Brazilian regulator now requires rating agencies to have a code of practice addressing the issues of:

- information sources to be used in the ratings;
- monitoring and timely update of ratings—except when they are clearly stated not to be updated;
- independence of the company and of their analysts with regard to any issued rating;
- potential conflicts of interest,
- the commercial relationships between the agency and their customers; and
- trading behavior in securities by the analysts of the rating agency.

And there are additional rules:

1. Whenever an analyst leaves a rating agency to work for a company which has been rated by that analyst, all work carried out by this professional in the previous two years must be subjected to a review.
2. Any ratings announcement must stress all potential conflicts of interest; for example, when the revenue from any one given rating is a significant share of overall revenue.
3. There must be a structural separation between the rating agency activity and any others conducted by the same company, such as consulting.
4. General further constraints on what is considered as acceptable behavior by the rating analysts, in addition to those of the code of conduct.

As for the international compatibility of such norms, on April 27, 2012, the ESMA (European Authority of Exchange and Securities Markets) announced that the Brazilian Regulation is in line with European rules, which implies European financial institutions can continue using ratings issued in Brazil for regulatory compliance.

V. CONCLUSIONS

This history and current overview of the industry allow us to draw some conclusions. First, even though there is a quite large demand for ratings as a result of regulatory requirements, the market for rating agencies in Brazil is bound to be smaller than in developed markets, because ratings issued by third-party companies are not allowed to be used by financial institutions to compute regulatory capital requirements.

On the other hand, the demand for such ratings is expected to increase in the next few years, due to an increased access to international financial markets and the associated regulatory requirements (two examples are the Brazilian Central Bank using ratings to choose foreign investments and financial institutions, and the Insurance Companies' regulator evaluating foreign reinsurers). Another source of demand for ratings is the demand for information on investment alternatives. Even though ratings are not required by regulators, they are still being made public by issuers as part of information disclosure.

In terms of potential competitive problems, the mandated registration requirement, together with the need to establish a solid track record, undoubtedly are strong barriers to entry. Furthermore, given the reputation already achieved by existing rating agencies, it is quite unlikely a new entrant could reach an important market share in a short time frame.

However, the likelihood of a major player unilaterally increasing prices is quite low. Since it is quite unusual for a rating agency to request exclusivity from a customer, the agencies seem to compete strongly for customers, increasing customers' bargaining power. Besides, in many situations, ratings are not required by the customers.

All in all, the lower regulatory demand of ratings, coupled with a lightly regulated supply of such ratings until 2013, makes Brazil an interesting case of a rather free market in rating agencies. The results of this experiment have not been an unqualified success, with some failures such as the case of Santos Bank. Future developments arising from the new regulatory framework remain to be seen.

CPI COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle

January 2014 (2)

Global Reform of Credit Ratings Agencies and Challengers From Emerging Markets

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Global Reform of Credit Ratings Agencies and Challengers From Emerging Markets

Trudi Makhaya[1]

I. INTRODUCTION

Concerns about the South African economy raised by credit ratings agencies are "not about numbers but about sentiment." This was how South Africa's Finance Minister Pravin Gordhan characterized the actions of credit rating agencies ("CRAs") in remarks made after delivering the country's Medium Term Budget Policy Statement in October 2013.[2] In various interviews, the Minister went on to provide a critique of the manner in which credit ratings agencies operate, touching on their perceived conflicts of interest and the quality of their analysis.

For emerging economies, the findings of credit rating agencies are crucial as they influence how the international investor community perceives a country's risk profile and its attractiveness as an investment destination. Credit rating agencies are relied upon to provide investors with information and guidance that serves as input into the analysis of securities and decision-making processes. For example, sovereign ratings provide an indication of the general business environment within a country and usually provide a ratings ceiling for the private sector. In playing this role, the views published by rating agencies have an impact on the cost of credit and access to capital markets, especially where local markets are small and opaque. The quality of CRA pronouncements and the cost of ratings also have a great impact on private sector companies that require ratings.

The dominance of the big three firms; Moody's, Fitch, and Standard and Poor's, is well-documented. The entrenchment of this dominance through regulation and legislation, starting with the endorsement of these three agencies by the United States as nationally recognized statistical ratings organizations, persists.

As the global financial crisis led to scrutiny of the ability of rating agencies to guide investors in assessing risk, key elements of their operating models have come to the fore as problematic. The dominant issuer-pays model, where the institutions issuing securities pay to be rated, distorts agencies' objectivity. The significance attached to the ratings issued by the big three is also being challenged, with governments across the G20, including South Africa, implementing measures to remove strict references to agency-issued ratings from legislation,

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[2] Financial Mail: *Gordhan slates rating agencies' sentiments on South Africa*. Troye Lund, (24 October 2013). www.financial mail.co.za. Accessed 20 January 2014.

regulations, and investment mandates. These measures also aim to encourage investors to form an independent assessment of credit risk beyond the assessments given by CRAs.[3]

In developing countries, the depth of analysis provided by these agencies, particularly in instances where they do not maintain a significant local presence but "parachute" analysts in and out of the country, has come into question. South Africa's Finance Minister, Pravin Gordhan, has argued that credit rating agencies have not given the country's policymakers enough credit for proper management of its economy. Since the dawn of democracy in 1994, South Africa received its first credit downgrade in 2012.

New entrants into the market for credit rating agencies have to contend with high barriers to entry. To be effective in the market, an agency needs to build a reputation for quality. However, quality is only observable *ex post* using a large sample of data. An agency also needs to produce ratings that are comparable across time and geography so as to create a standard that investors become comfortable with. Thus, the greater the coverage of an agency, the more valuable it becomes to investors. Investors also do not want to have to invest resources in understanding and interpreting many standards. Issuers also prefer to build trust with a few rating agencies; and prefer to receive ratings from agencies that are trusted by investors. All these factors tend to favor concentration.

As a response to the perceived challenges in this market, competition has been offered as a solution. Competition may improve the quality of ratings. However, competition has also been found to generate problems, as in the case of "ratings inflation" observed in the United States with the rise of rivals to the big three, due to the ability of issuers to play agencies off against one another to obtain favorable ratings.[4] This type of forum shopping, in the context of an issuer-pays model, highlights the ways in which other reforms are necessary to ensure that greater competition leads to desirable outcomes in the market.

II. INITIATIVES TO REGULATE CREDIT RATING AGENCIES IN SOUTH AFRICA

Five credit rating agencies operate in South Africa, commonly known as Moody's, Fitch, Standard and Poor's, Global Credit Rating Co., (GCR) and Ratings Africa.

In South Africa, credit ratings issued by CRAs are required by law in various contexts. For example, banks use credit ratings in calculating the prescribed minimum amount of required capital and reserve funds. Municipalities may only invest in instruments with an investment grade rating from a nationally or internationally recognized agency. In the private sphere, most fund managers have mandates that are determined with reference to credit ratings.

South Africa is implementing recommendations made by the G20 countries with regards to the regulation of agencies. These recommendations seek to create a globally consistent regulatory framework for agencies, which include the mandatory registration of CRAs.

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[3] Financial Stability Board: *Credit Rating Agencies – Reducing reliance and strengthening oversight. Progress report to the St Petersburg G20 Summit*. 29 August 2013. www.financialstabilityboard.org/publications Accessed on 20/01/2013.

[4] OECD: *Competition and credit ratings agencies*. Note from the Secretariat. DAF/COMP (2009) 39.

South Africa passed the Credit Rating Services Act No 24 of 2012, whose provisions became fully operative on December 17, 2013. This legislation provides for the registration of credit rating agencies, the regulation of their activities, the conditions for the issuing of credit ratings, and the organization and conduct of CRAs. In terms of this act, credit ratings can only be issued by a registered credit rating agency. Agencies must ensure that they have the capacity to issue sound ratings and must review the quality of their methodologies and ratings regularly.

The Act also provides for various disclosures that agencies must make to the public (such as its methodologies and assumptions, code of conduct, nature of compensation arrangements, and default rates of its rating categories) and to the registrar (such as its top clients and how revenue is split among them). The act also calls for the registrar to have regard to the "principle that competition between regulated persons should not be impeded or distorted." The act also sets out some elements that may be included in memoranda of understanding with regulatory authorities in other jurisdictions.

The competition authorities have jurisdiction over CRAs in the conventional areas of merger control, exemptions, and also anticompetitive conduct (unilateral conduct and horizontal restraints such as collusion). However, these powers are exercised in response to conduct by CRAs. Like in most areas of the economy, effective competition also requires policies that shape the rules of the game in a pro-competitive manner. The Credit Rating Services Act features elements that support competition.

It has been argued that measures to increase transparency in CRAs enhance competition as they allow users to compare the processes and performance of CRAs. As mentioned above, CRAs registered in South Africa will be required to disclose their methodologies and the default rates of the categories that they rate. This should also enable new entrants or non-big three players to be able to demonstrate their competitive advantage to issuers and users of ratings.

In December 2013, Fitch South Africa and Global Credit Rating Company were registered under the new legislation. The applications for Moody's and Standard and Poor's are still under consideration and these agencies are operating under time-bound exemptions.

III. CHALLENGERS FROM EMERGING MARKETS

The creation of Arc Ratings through the combination of CARE Rating (India), Global Credit Rating Co. (GCR, South Africa), MARC (Malaysia), SaeR (Portugal), and SR Rating Group (Brazil) occurs against the backdrop of regulatory changes meant to enhance competition. This follows the emergence of another challenger to the big three—Universal Credit Rating Group, a joint venture among Dagong Global Credit of China, Egan-Jones Ratings of the United States, and RusRating of Russia, with headquarters in Hong Kong.

South African-based GCR began its life as a subsidiary of U.S.-listed CRA Duff and Phelps. According to the company, it accounts for the majority of ratings in Africa. The company rates all security classes. Over the years, GCR has attracted investment from development finance institution DEG/KFW group (stake acquired December 2007) and French government-owned Proparco (stake acquired 2009).

The rationale provided by Proparco for its investment in GCR was to improve the provision of financial information in the West and Central African Economic and Monetary

Unions as a way to improve the efficiency of financial markets in this region and to act as a catalyst for foreign investment into the region.[5] This rationale, couched in terms of encouraging private investment into the region, suggests that the big three were not particularly active in this part of the world, whereas GCR had experience in "difficult" emerging markets.[6]

GCR sees its value proposition as its insight into the unique characteristics of emerging markets—giving it what is considers the largest subscriber base in that market. It estimates that in Africa, it accounts for 60 percent of ratings. Arc Ratings has introduced new methodologies to its product range, including a systemic risk rating and a financial stability ceiling. These methodologies aim to give clients insight into general risks across an economy and a different approach to determining a country's ratings ceiling.

It remains to be seen whether Arc Ratings and/or Universal Credit Rating will act as effective constraints on the big three agencies. In press statements, these emerging markets challengers have sometimes portrayed themselves as offering a "complementary" service to the big three, especially given the industry practice of seeking ratings from two agencies. The entrants seem to envisage a world where issuers would seek a rating from one of the big three CRAs and an emerging markets player.

IV. CONCLUSION

Global developments in policy towards CRAs favor adding constraints to their influence by reducing the weight placed on ratings in risk assessments and regulations and also through the introduction of competition. South Africa conforms to this trend, with new legislation passed to enhance transparency and competition between CRAs.

In line with G20 policy reforms, financial regulators have also embarked on measures to remove hard references to agency-issued ratings in legislation and regulation. The emergence of Arc, which includes the leading ratings agency in Africa, GCR, occurs against the backdrop of these pro-competitive reforms. These reforms suggest the need for closer co-operation between competition authorities and financial regulators with oversight over CRAs.

[5] Proparco/GCR press release: *Proparco acquires stake in global credit ratings* (16 November 2009).

[6] Proparco Note: *Contributing to the development of capital markets in Africa*. www.proparco.fr. Accessed 20 January 2014.