Regulation of Credit Rating Agencies - Different Views and Solutions

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Abstract

Credit rating agencies are an important element of the informational financial infrastructure, which is essential for the stability of the financial system. In the absence of conflicts of interest and the importance of the established reputation for the rating agencies, self-regulation is sufficient to guarantee high-accuracy ratings. The payment for ratings by issuers and their use in financial regulations create distorted incentives to pursue higher profits at the expense of the quality of ratings. The demonstrated failures of the rating agencies confirm the need for strict regulations to restore investor confidence in the ratings.

Keywords: rating agencies, credit ratings, regulation

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Introduction

The regulation of credit rating agencies has been subject of extensive discussion and change in recent years. The global financial crisis has exposed the significant failures of rating agencies and their systematic importance for the stability of the financial sector. The inability of self-regulation to provide high-quality ratings with valuable information content requires an explanation of the problems and identification of measures to solve them. The main way to improve ratings is mandatory and strict regulation which reduce conflicts of interest, promote competition and increase the responsibility of rating agencies.

1. Reputational capital and self-regulation

The financial regulation, including rating agencies, depends on the extent to which participants can function effectively without external interference or severity of market failures that require adoption and application of specific rules. For a long time, credit rating agencies had been running their business without formal rules, self-regulating. The main argument for self-regulation is the view of agencies as gatekeepers and the concept of reputational capital. The fundamental function of rating agencies is to provide information. Ratings can overcome the information asymmetry between creditor and debtor by involving a third party to certify the debtor's creditworthiness. From this perspective, the credit rating agency is a gatekeeper of debt securities markets, which verify information about the issuer’s financial condition and certify its creditworthiness by assigning a credit rating (Coffee, 2004; Partnoy, 2006).

The need for rating agencies is determined by the information asymmetry between the issuer and the investor in a debt instrument. If the seller has complete information about the product he is selling and the buyer is not able to assess the quality of the product, the “lemon” problem arises (Akerloff, 1970). The situation is similar in the bond market, where issuers (sellers) have an information advantage over investors (buyers). This information asymmetry will cause inefficiencies and even market collapse. Information asymmetry can be resolved if sellers can send a credible signal to buyers about the actual quality of the product (Spence, 1973). Buyers will trust the signal if the losses from sending a false signal outweigh the benefits. In debt securities markets, the credit rating act as a signal. When a rating agency assigns a rating, it gives a signal to investors about the creditworthiness of issuers. This signal enables them to differentiate the securities according to their quality and to determine adequate market prices. To play its role the rating must be a credible signal. If an agency systematically has true estimates of issuers’ credit risk over time, it builds a reputation among investors. The reputation building requires additional costs for high quality analysis, but rating agency receives higher fees due to the higher reputation among investors. The credit rating will be a reliable signal, because if the rating agency assigns a false rating, its gains will be much smaller than the losses. In short run the agency would receive additional fees form incorrect high ratings because it will attract more issuers. In the long run, however, the agency will suffer much greater losses due to damaged reputation and related rents (Dittrich, 2007, 21).

The idea of reputational capital has a long history[1] and has been applied to debt markets and credit rating agencies (Diamond, 1989; Mann, 1999; Partnoy, 1999; Brookfield and Ormrod, 2000; Schwarcz, 2002; Smith and Walter 2002). Until the beginning of the 21st century, the view that rating agencies certify creditworthiness based on their established reputation is widespread and accepted in theory and practice (Partnoy, 2002, 67-68). Any specific regulation is not needed, because the problems are solved by market forces. If a rating agency assigns incorrect ratings, it will lose its reputation and customers. New players, who offer better ratings, will enter the market. The three major credit rating agencies (Moody's, S&P, and Fitch), which have been successful for decades, are cited as evidence of the reputational capital they have acquired and an argument against strict regulation.

If the established reputation is important, the rating agencies themselves have an interest in improving their activities and no external supervision by a state regulator is needed. In this case, self-regulation is more appropriate. Self-regulating rating agencies set their own rules or adhere to generally accepted ones without being coerced. In self-regulation, there are no penalties for breaking the rules. The control is only by internal procedures or by criticism from market participants. In this regard, in case of deviation from the rules, the agencies must publicly explain the reasons for this ("comply or explain" principle).

For a significant period of time (actually until the global financial crisis), the activities of rating agencies had been largely subject to self-regulation, and this was considered to be sufficient (Gillen, 2008). Each rating agency had adopted its own internal rules that govern its rating process. Aiming more efficiency and unification in 2003 International Organization of Securities Commissions (IOSCO) published Principles Regarding the Activities of Credit Rating Agencies (IOSCO, 2003). The principles referred four areas: quality and integrity in the rating process; independence and conflicts of interest; transparency and timeliness of ratings disclosure and confidential information. The four main principles are: 1) Credit Rating Agencies should endeavor to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants.; 2) Credit Rating Agency ratings decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the Credit Rating Agency's ownership structure, business or financial activities, or the financial interests of the Credit Rating Agency's employees. Credit Rating Agencies should, as far as possible, avoid activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of the credit rating operations.; 3) Credit Rating Agencies should make disclosure and transparency an objective in their ratings activities.; 4) Credit Rating Agencies should maintain in confidence all non-public information communicated to them by any issuer, or its agents, under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.

To specify the Principles in 2004 IOSCO published Code of Conduct Fundamentals for Credit Rating Agencies, amended in 2008 and 2015 г. (IOSCO, 2004; IOSCO, 2008, IOSCO, 2015). All three leading rating agencies (Moody's, S&P, and Fitch) have implemented IOSCO Principles and Code in their own internal rules (Fitch Ratings, 2017; S&P Global Ratings, 2018; Moody's Investors Service, 2020). However, all three agencies exclude liability for damages for

[1] The value of reputation in economic relationships was discussed by Adam Smith (Smith, 1766, 253-254). More complete model of the reputation mechanism was developed by Shapiro (1983) for product markets.

violating their code of conducts. Deviations from the IOSCO Principles and Code are only explained, but the agencies are not penalized for such deviations.

2. Regulatory license, conflicts of interest, and need of strict regulation

For decades, the reputation model had been applied to rating agencies. Ratings had been considered to have positive value for the markets and significant changes had not been needed (Hill, 2004). The events in end of the 20th and the beginning of the 21st century, however, questioned this view. In a number of cases of financial trouble and bankruptcy (Penn Central bankruptcy in 1970, New York City fiscal crisis in 1976, Orange County default in 1994, Asian financial crisis in 1997, collapse of Long-Term Capital Management (LTCM) in 1998, Enron and World-Com bankruptcies in 2001) agencies assigned too high (investment) ratings, lowering them shortly (and too late) before defaults and thus not responding in time to the increased credit risk (Moosa, 2017). With the beginning of the subprime crisis in 2007, led to the global financial crisis of 2008, the failure of rating agencies to provide accurate and timely assessments, especially with regard to structured finance products, finally became clear. The ratings assigned to a significant number of instruments were too high and inflated, changing slowly as market conditions change (White, 2013). There is a consensus that rating agencies are one of the factors that have contributed to increasing systemic risk and deepening the crisis (Moosa, 2017; Partnoy, 2017). Large rating agencies were fined with significant amount of money[2] and acknowledged that they had lowered their standards and intentionally inflated their ratings (Joffe, 2018).

The issues with quality and reputation of rating agencies can be explained by changes in their business model and regulations. Initially, the agencies received fees from bond investors. In the investor-pays business model, agencies assess the creditworthiness of issuers and sell this information to investors. Thus, rating agencies have an interest in maximum accuracy of ratings, because otherwise investors will not pay for their services. In the late 1960s and early 1970s agencies adopted issuer-pays model[3], which is used in the present. Under this model, rating agencies receive their revenues from issuers and become dependent on them. The agencies have an incentive to overrate the creditworthiness of the debtors and to determine a rating higher than the actual one because by doing so they will attract more clients and will not lose present ones who would go to another agency. This is in conflict with investors' interests requiring adequate assessments of the issuer's credit risk. Dependence on issuers is also increasing by the additional services (e.g. consulting) that rating agencies provide when issuing debt securities.

Changes in financial regulations are also essential. After the 1930s in the United States was introduced the restriction that various financial institutions (first banks and then insurance companies, pension funds) could buy and hold only investment grade securities and investment in speculative securities was prohibited. Determination of investment and speculative grade is based on "recognized rating manuals" e.g. credit ratings (White, 2013). In 1975 the regulatory use of ratings deepened with the use of credit ratings in determining the capital requirements for securities firms. The important change was that only ratings assigned by a nationally recognized statistical rating organization (NRSRO) can be used for regulatory purposes. The three major rating agencies were certified for NRSRO, thus gave them the status of quasi-regulatory bodies. In the following years, the regulatory use of only NRSRO ratings was also introduced for banks, investment companies and other financial institutions (Partnoy, 2002, 72-78). With the development of

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[2] In settlement agreement with The Department of Justice and several states S&P paid $1.375 billion penalty and admitted that the company declined to downgrade underperforming assets because it was worried that doing so would hurt the company's business (US Department of Justice, 2015). In similar agreement Moody's paid nearly $864 million and admitted that company used a more lenient standard for Aaa structured instruments and did not issue publications about this practice to the general market (US Department of Justice, 2017).

[3] In 1968 S&P adopted issuer-pay model for all municipal bonds. In 1970 Moody's began charging issuers for both corporate and municipal bond ratings. In 1974 S&P began charging corporate bond issuers too (Jiang, Stanford, and Xie, 2012).

financial markets, the regulatory status of ratings extends to other countries. In the EU, ratings are used in a number of financial regulations (Blaurock, 2007). They are often used in a number of other countries (BIS, 2000). With the implementation of the Basel II Accord (International Convergence of Capital Measurement and Capital Standards: A Revised Framework) after 2004 (BIS, 2004), the regulatory license of ratings became global. Ratings are used by regulators to restrict investment and set capital requirements for financial institutions. Rating agencies became private institutions with regulatory status and their services are mandatory for investors and issuers. Thus, ratings must be used regardless of their quality and there is no market mechanism to remove agencies with incorrect credit risk assessments of issuers.

The regulatory license and the issuer-pays model are the reasons for the failure of the reputation view. A third party to send a reliable signal and certify the quality of an asset, three conditions must be met (Megginson and Weiss, 1991). First, the certifying agent must have reputational capital at stake, that can be lost in wrong certification. Second, the value of the agent's reputational capital must be greater than the largest possible gain from false certification. Third, it must be costly for the issuing firm to purchase the services of the certifying agent, and the cost must be increasing with the increase of information asymmetry. These condition can be applied to reputational capital model of credit rating agencies. Rating agencies have reputational capital that they can lose by assigning wrong ratings. Reputational capital losses may be greater than the additional fees rating agencies could receive from a false rating. Ratings are costly, and the cost could be higher if they have more information content. But the three conditions are not satisfied by rating agencies (Partnoy, 1999). First, rating agencies have little reputational capital at stake. Due their regulatory status, investors have no choice but to trust them. In addition, agencies can easily achieve minimum reliability of ratings by following the changes in the prices of the debt instruments they assess. Second, the gain from inaccurate ratings vastly exceeds the cost of any loss in reputational capital. Due to the issuer-pays model, rating agencies can receive significantly higher fees if they set higher ratings. This is especially true for structured finance products - the history of the global financial crisis has shown that by assigning inflated ratings rating agencies made huge profits without worrying about losing their reputation. In addition, the agencies' assessments are treated as opinions and they do not bear legal liability. Third, the agencies' services are not costly to copy. Rating movements just follow the debt markets and ratings are easy to be predicted after the market events. Because reputational capital can not provide reliability of credit ratings self-regulation does not work.

Another argument against self-regulation is the protection of investors' rights. The ratings affect their interests for two reasons. First, rating fees are part of the issuance costs and thus increase the issue price paid by investors. Second, due to the regulatory use of ratings, investors are required to reckon with them in their investment decisions. In the absence of regulation, investors can not sue rating agencies because they do not enter into a contract with them and do not have a direct relationship. In this regard, formal rules are needed to make agencies accountable to investors.

The need for statutory regulations is also determined by the deterrence effect (Hemraj, 2015, 22-24). If rating agencies self-regulate, they will not face sanctions for violating the rules. If the reputation is irrelevant, they will continue to harm the interests of investors. Statutory regulation includes penalties for violations that have a deterrent effect on the behavior of rating agencies, harmful for the interests of investors and other stakeholders.

The described arguments substantiate the need for strict regulation of the activity of rating agencies. Regulations should be mandatory and enforced by a state regulator, which would impose sanctions for violation of the rules.

3. Current state and perspectives for regulation

The need for strict regulation of rating agencies has been undoubtedly confirmed by the global financial crisis. As a result, in most countries mandatory rules have been introduced[4] in the following areas:

• Increasing competition. Clear rules for the registration of rating agencies are introduced, which apply equally to all. Agencies are prohibited from forcing issuers to use their services by lowering ratings or selectively changing the methodologies for determining them. Unsolicited ratings are regulated and must be clearly marked and distinguished from the others. In structured instruments, rating agencies are required to provide access to all information available and used to determine the rating of that instrument to any other registered agency that requires access to such information. In addition, in the EU, agencies must make publicly available all information on the loss and cash flow analysis on the basis of which structured instruments are valued. In order to stimulate competition and increase accuracy, EU regulations require a structured finance rating to be assigned by at least two agencies. European rules also require issuers to consider hiring a smaller rating agency (with less than 10% market share) in cases where two or more rating agencies are hired. If such a smaller agency is not hired, this must be documented.

• Reducing conflicts of interest. As a general principle, rating agencies must identify any conflicts of interest that may lead to the inadequate ratings and organize their activities in a way to avoid such conflicts. In particular, persons who are related to or receive remuneration from the issuer or another party with an interest in it shall be prohibited from assigning the rating. In addition, the remuneration of the persons assigning the ratings can not depend on the revenues that the agencies receive from the rated companies. Credit specialists have to be rotated so that an expert does not participate in determining the rating of the same issuer for an extended period of time. Rating agencies are prohibited from providing additional advisory services that directly affect the credit rating, including the design of structured finance products. The agencies are obliged to appoint a compliance officer to monitor compliance with all regulatory requirements, as well as to maintain a review function that monitors the adequacy of the applied methodologies. The activity and remuneration of the compliance officer and the rating monitoring service must be independent of the rating activity.

• Ensuring transparency of credit rating agencies. In this regard, regulations require agencies to disclose detailed information on: legal structure and ownership; large customers; revenues from rating assessment; revenues from additional services; potential conflicts of interest and the system for avoiding them; assigned ratings; rating methodology, quantitative models and the assumptions in them; the percentage of defaults by individual rating categories, as well as other data needed to assess the rating accuracy; the results of compliance assessment with the regulations, etc. Agencies should provide public access to information on the history of their ratings, which should be in structured and machine readable format[5].

• Liability of rating agencies. In the event of a legal requirements violation, regulators have the power to hold agencies accountable, including by imposing various penalties – fines, periodic financial sanctions, temporary ban on the issuance of credit ratings, suspension of the use of ratings for regulatory purposes, termination of the registration of the agency. The affected persons can seek in court compensation for damages caused by the activities of rating agencies, but it is not absolute. In the US, private claims can be dismissed on the basis of protection of freedom of speech, while in the EU investors and issuers can seek damages, but only to the extent that relevant national law allows.

[4] In the USA the regulations were introduced with Credit Rating Agency Reform Act of 2006 and Dodd-Frank Wall Street Reform and Consumer Protection Act from 2010. In the EU was adopted Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies. Similar regulations were adopted in many other countries (Kruck, 2011; Darbellay, 2013).

[5] In the USA rating agencies must provide on their internet sites information on ratings for the (history of ratings) in XBRL (eXtensible Business Reporting Language) format with standard taxonomy. In the EU European Rating Platform provides public access to information on rating agencies and historical data of their ratings.

• Limiting the regulatory use of ratings. In this respect, US and EU approaches differ. In the United States, a more radical approach is used by removing regulations based on ratings, including those of banks, investment companies and other financial institutions. All federal agencies must remove any reference to credit ratings. However, this requirement does not apply to the supervision of defined benefit pension funds, as well as insurance companies, which are regulated at the state level. In the EU, financial institutions are required to have their own credit risk assessment of issuers or financial instruments, which can not be based solely on a rating. However, this allows ratings to be used in combination with other indicators in credit assessments, which partially preserves their regulatory status.

The credit rating agencies regulations introduced in the last decade have had a positive impact, but there are still some unresolved issues in this field. The oligopolistic situation in the credit rating market has not changed, with the three large agencies still having over 90% market share. Although there has been an improvement in compliance with the rules, rating agencies still infringe regulations of transparency, compliance with adopted policies, procedures and methodologies, prevention of conflicts of interest, quality of internal control mechanisms in assigning ratings, corporate management, etc. (SEC, 2020). The disclosed methodologies applied in determining credit ratings are not transparent enough, contain many subjective elements and can not be re-applied by an outside person. Rating agencies still react slowly, usually reviewing ratings once every few months. The informational content of the ratings can be increased – in addition to the rating as a combination of letters, which reflect relative probability of default, the rating agency can provide an assessment of absolute probability of default, loss given default and recovery rate.

To overcome the described issues, the following changes in the regulations of rating agencies can be recommended:

• Complete removal of the regulatory status of ratings. This requires changing the whole set of regulations of the financial system, removing any reference to ratings in determining capital requirements, restrictions on investment policy, liquidity management and other regulated aspects of the activities of all financial institutions. The financial institutions should implement their own credit risk assessment methodologies that are subject to supervision for accuracy. Removing the regulatory use of ratings requires not only changes in rules, but also an increased organizational, human and financial capacity of financial regulators in order to adequately evaluate the accuracy of the credit risk assessment systems used by supervised institutions. In this regard, a good example is banking regulation, where the development, implementation and supervision of internal credit risk management systems without reference to outside ratings is widespread (White, 2016). In addition to changes in financial regulations, governments and other public organizations should not mechanically use ratings to determine their investment policy and cost management. They may independently perform own credit risk analyzes or outsource them on a competitive basis to external credit analysts, including rating agencies.

Removing regulatory requirements based on credit ratings will put strong pressure on rating agencies to improve accuracy and information content of their rating systems, because they are going to lose their market power and will have to compete with all entities that specialize in analysis of credit information. If this is achieved, the strict regulations of the rating business can be removed, including elimination of registration and licensing. Ratings will be treated as investment advice and agencies will only have to comply with requirements for liability and protection of clients' interests. The lower barriers of entry for new players, reduced cost of enforcing regulations, increased competition and innovation will further improve the volume and quality of information in credit markets.

However, until the complete removal of the regulatory use of ratings, the current regulations must be enhanced in the following directions:

• Global harmonization of regulations. Although many of the rules regulating rating agencies are similar in the US, the EU and other financial markets, there are still differences that allow rating agencies to benefit from the most "liberal" regime in different countries. The global nature of the big agencies requires a global approach in regulation. International convergence is facilitated by common regulatory problems and goals in different countries. The International Organization of Securities Commissions (IOSCO) is an appropriate platform for reaching global agreement about rating standards (Campos, 2004).

• Regulation of rating agencies by an independent and autonomous regulatory authority. Rating agencies' functions are similar to those of registered auditors and their supervision should be carried out in a similar way – by a separate and independent body. At present, supervision is in the competence of the regulators of the securities markets. This facilitates close and intensive relations between regulator and issuers, investors and rating agencies, which make supervisors dependent on the supervised (Partnoy, 2017). From this point of view, a separate supervisory authority is more appropriate.

• Stimulating competition and mitigating conflicts of interest. In this regard, appropriate measures are:

- facilitating access to information for credit risk analysis. The assessment of the probability of default is based on data from financial statements of the issuers and market value of their securities. At the moment, part of the information is public, as it is disclosed through the commercial registers and the registers of financial regulators. The main impediment to analysis is the unstructured form of this information, which is difficult and expensive to collect and process. To facilitate access, requirements about information disclosure should be introduced. The issuers have to publish all data in a structured form that is easy to machine processing (Joffe, 2018). The most appropriate is the XBRL format with standardized structure. In addition to companies, central and local governments, and other public organizations that issue debt securities must publish data in a structured form.

If the issuers are not public companies and are assigned a rating, they should be required to disclose the same information as public companies. Disclosure of information should also apply to structured finance instruments, including the characteristics of the assets to be securitized. A disclosure requirement should also be introduced for local authorities and public organizations to which a credit rating is assigned (White, 2016).

Having detailed, publicly accessible and computer readable information on issuers and securities will greatly facilitate credit analysis and enable smaller agencies and independent analysts to provide credit evaluations that are alternative to ratings. Greater public awareness will make rating agencies more responsible. They will not follow demand of issuers for higher ratings, because such behavior will be easily noticed.

- accepting alternative assessments for regulatory use. Competition in credit risk analysis may increase if, in addition to the ratings of registered agencies, the opinions of independent analysts are recognized for regulatory purposes (Joffe, 2018). Regulators may accept the analyses made by academic researchers, research centers, universities and non-profit organizations that have credit market expertise. If their methodologies are well documented, publicly disclosed and approved by regulators, they can be used as an alternative to credit ratings.

- rotation of rating agencies. Similar to auditors, when an issuer uses the services of a rating agency, after a certain period the issuer must change the agency (Jeon and Lovo, 2013). This will promote competition and limit the agency's commitment with issuers and the resulting conflict of interest.

- fee regardless of the rating. If issuers pay fees to rating agencies before the rating is assigned or before the selection of rating agencies, it will reduce the incentive to set inflated ratings (New York State Attorney General, 2008).

- disclosure of fees payed by issuers to rating agencies for ratings and other consulting services. There is a similar requirement for audit services, and the disclosure of such information will show investors the degree of dependence of agencies on issuers and will provide an indication of a conflict of interest (Jiang, Stanford, and Xie, 2012).

• Greater transparency of rating agencies. In this regard, rating agencies should publish a detailed description of the quantitative methods they use so that they can be applied and verified by outsiders. This will significantly facilitate external control over their activities. In addition, when an infringement is found, the regulator has to disclose the agency committed the infringement and what exactly it is. Currently, regulators only report identified violations and do not disclose names of agencies.

• Increased liability of rating agencies. The regulations must allow all persons concerned to claim in courts compensations for damages from the rating agency infringed the rules. It must be clearly defined in which cases the compensation is due and the possibility of excluding liability must be removed, including on the basis of arguments such as the protection of freedom of speech or gaps and exceptions in civil law.

Conclusion

Credit rating agencies are important participants in debt markets that reduce information asymmetry about credit risk. As gatekeepers, they can send a credible signal to investors about the issuer's creditworthiness. If rating agencies have trust and accumulated reputational capital, no mandatory regulations are needed and they can self-regulate. However, the global financial crisis has shown that the model of reputational capital and self-regulation does not work. The main reasons are the transition to issuer-pays business model and the widespread use of ratings for regulatory purposes. These developments create significant conflicts of interest with investors and minimize the importance of reputation for agencies. This justifies the need for strict regulation of rating agencies, which was introduced in the last decade. Regulations have introduced rules to reduce conflicts of interest and increase transparency and liability of rating agencies.

Despite significant progress, further improvement of regulations towards the complete removal of regulatory status of ratings, global harmonization of regulations, and greater competition, transparency and liability of rating agencies can be recommended.

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