A New Regulatory Framework for Credit Rating Agencies

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INTRODUCTION

The regulation of credit rating agencies (CRAs) has not been seriously addressed for too long. Until recently, the agencies themselves argued that regulation was not required, since in their view users would approach a CRA for a rating only if its opinion carried credibility with the investors. Their reputation was at stake and therefore it was in their own interests to maintain a high standard of quality. For years, this reasoning postponed any regulation of CRAs. However, the latest crisis has put an end to that.

The 2007–2009 global financial crisis continues to have a profound impact on the global economy. Worldwide, most economies suffered a dramatic economic decline, with contracting GDP, surging unemployment rates and many large corporate bail-outs and bankruptcies. In some countries, the stability of the entire financial system was compromised, resulting in large-scale overhauls of the banking sector.

There is a general consensus that loopholes in the regulations of the credit rating industry were a major contributing factor in the collapse of the global financial system. These loopholes are considered to have encouraged the malpractices of credit rating agencies, thus helping to precipitate the financial crisis. As part of the general initiative to increase the resilience of the financial system, many governments and organizations have signaled or have already taken action to strengthen the regulatory framework governing the credit rating industry.

The post crisis era has witnessed the enactment of several regulations that are expected to fundamentally change the operations of CRAs. This article highlights the most important attempts at regulation that have recently been undertaken by various regulatory authorities and non-regulatory bodies worldwide. In addition to the regulatory overhaul, we also cover some of the non-regulatory responses that are currently being offered by governmental and non-governmental entities.

I. CRA REGULATIONS 2008–2011

1.1 The Dodd-Frank Act and its Impact on the Credit Rating Industry in the US

On July 21, 2010, US President Barack Obama, signed the Dodd-Frank Act into law. The final Act is over 2,300 pages long and influences the US financial services industry in almost every aspect. The ultimate objective of the Act is to restore public confidence in the financial system, prevent future financial crises of comparable magnitude, and allow future asset bubbles to be identified and deflated before another crisis hits the financial markets. To attain this goal, the Dodd-Frank Act, amongst others, includes further regulation of CRAs, by enhancing the Securities and Exchange Commission's enforcement mechanisms, and by adding a number of requirements on Nationally Recognized Statistical Rating Organization that immediately came into force. This new regulation is the most important CRA regulatory development to occur in the US since the 2008 financial crisis.

The provisions in the Dodd-Frank Act are intended to address the various credit rating problems that emerged from the 2008 financial crisis. Before elaborating on these new provisions, it is important to clarify the term "Nationally Recognized Statistical Rating Organization" (NRSRO) in its US context. NRSRO is a designation issued to CRAs by the Securities and Exchange Commission (SEC). This designation is important because various regulatory authorities have customarily relied on credit ratings from NRSROs for distinguishing between grades of creditworthiness in various regulations, under the federal securities laws.

The Act aims to revamp the credit rating industry by introducing a series of rules pertaining to compliance, internal control, rating quality, disclosure of information, reporting and reviewing, management of conflict of interest, and rating user protection. Below is a summary of the major regulatory changes from the act:[1]

1.1.1 The Major Regulatory Changes Addressing CRAs from the Dodd-Frank Act

Look-back review: To better manage conflicts of interest, NRSROs must establish and enforce a look-back policy. If an employee of an issuer, obligor, or underwriter of a money market instrument was previously employed by an NRSRO and had participated in determining the ratings for the instrument during the one-year period preceding the rating action, the NRSRO must assess the likelihood of any conflict of interest.

Suspension or revocation of registration: The SEC may suspend or temporarily revoke the NRSRO registration of a CRA if it fails to provide ratings with integrity over time.

Removal of statutory reference of credit rating (LeMieux amendment): References to credit ratings in certain laws are required to be removed, effective 2 years from the enactment. Regulatory bodies are required to substitute an alternative standard of credit-worthiness for external credit ratings.

Private action against NRSROs: The credit ratings delivered by NRSROs are no longer considered "forward-looking statements" but instead are treated as "expert opinion." As a result, NRSROs will be liable for their ratings as in the case of accountants or auditors. Under the new law, investors can sue NRSROs if it can be proved that the NRSRO "knowingly and recklessly failed" to conduct reasonable investigation into and verification of their basis of rating, which led them to fail to provide ratings with integrity.

Role of the SEC: The SEC is charged with more responsibilities in supervising and overseeing CRAs. Under the new act, the SEC must establish a new Office of Credit Ratings, which will conduct an annual examination of each NRSRO, and issue a public annual report summarizing its essential findings.

Al Franken amendment: This amendment was proposed by Senator Al Franken and was passed by the Senate on May 13, 2010. The amendment proposed to set up a clearinghouse board that would assign CRAs to issuers on a quasi-random basis. While many commentators asserted that the amendment would help to eliminate the conflict of interest inherent in the issuer- pay business model, others feared that such quasi-random mechanism would further reduce competition and curb innovation in the credit rating industry.[2] Amidst concerns over the uncertainty of its impact and the difficulty of its implementation, the Al Franken amendment failed to make it through the final round and become part of the Dodd-Frank Act. Nonetheless, the proposed amendment urged the government to request the Comptroller General of the United States to conduct a further study of alternative business models for NRSROs, and to report results within one year after the date of the enactment.

1.1.2 The Unexpected Challenges of the Dodd-Frank Act

On July 20, 2010, one day before the Dodd-Frank bill was signed into law, the bond market went into turmoil after Moody's Investor Service, Standard & Poor's and Fitch Ratings withheld permission for issuers to use their credit ratings in their official documentation of bond issuance. This move by the agencies was a direct consequence of the action against NRSROs under the Dodd-Frank Act. The CRAs stated that with the new law in effect, they would limit the use of their ratings until they got a better understanding of their legal exposure. Since the issuance of bonds requires a rating in the official issuance documents (e.g. prospectus and registration statement) by law, many companies had put their bond offerings on hold at the withdrawal of permission from CRAs to use their credit ratings. In light of this unintended consequence on the market, the SEC decided to grant a six-month transition period during which bond issuers were exempt from quoting credit ratings. However, the SEC emphasized that the waiver does not change or negate the new laws governing ratings agencies.

Prior to the final enactment of the Dodd-Frank bill, Moody's had already expressed on April 21, that it would consider limiting its rating service from small and marginal users in the new regulatory environment. Standard & Poor's also issued a release on July 17, saying it would "explore mechanisms outside the registration statement to allow ratings to be disseminated to the debt market."[3] Earlier in December 2009, Standard & Poor's had already expressed the concern that rescinding the "expert" exemption for credit ratings in securities registration statements "would result in troubling and unintended consequences for the market, including reduced transparency due to issuers providing less information to investors."[4]

With the new provisions requiring the removal of statutory references to NRSRO ratings, the use of external credit ratings is starting to get restricted. Since August 11, 2010, regulators have taken measures to stop referencing credit-rating firms as a way to gauge banks' capital levels. In the past, regulators were allowed to use certain credit ratings to determine how much capital banks would need to hold as a cushion against possible losses. With the Dodd-Frank Act in effect, regulators are now being forced to come up with a new approach to risk measurement. However, as external credit ratings have been in use for a long time, it is not easy for regulators to develop a perfect substitute instantly. In addition, to comply with other provisions in the financial overhaul act, regulators are to push banks to hold more capital. Problems may arise as presently they do not have any concrete risk measure to determine how much capital banks need to reserve.

John Dugan, the US Comptroller of the Currency and an FDIC board member, expressed his worries over the likelihood of finding a perfect substitute given the time frame, "I do worry about there is a little bit of throwing out the baby with the bath water. It might be worth Congress taking a second look at."[5] "While large banks may employ expensive risk measurement models to determine credit risk, such models may not be easily available for the thousands of smaller US banks. Hence, it poses a great challenge for regulators to find an alternative that can be widely applied in any segment of the capital market."[6]

It was not until two years after the onset of the financial turmoil that the landmark financial reform bill was ultimately passed by the US regulators (July, 2010). Despite the enactment of the new act, it will be a long time before the act is fully implemented. In fact, in July 2010 when regulators took the first steps to enforce the new regulations, many unexpected consequences emerged to challenge the subsequent process of enforcement (see exhibit 1.1.2).

The US government has been pioneering in introducing the post-crisis financial overhaul bill. However, now less than a year since the Dodd-Frank Act attempted to require higher standards of conduct from credit rating agencies, regulators appear to be beating a hasty retreat. Even though Congress made it clear that it wanted to make the agencies more liable, legislators and regulators have been prevented from enforcing the new rules. Furthermore, there are new initiatives that — from an investor's perspective — would make things even worse than before. Representative Steve Stivers, for example, supports a new law which if passed, would give agencies the same protection from liability that they enjoyed before the crisis.

Even if this proposed reversal is not passed, several problems remain. Ultimately, the Dodd-Frank Act requires that references to NRSROs be removed from federal regulations. However, excluding references to ratings in regulations does not mean that ratings will not be used by private parties. It merely implies that ratings will not be disclosed, in official documents, which again tends to reduce the credit ratings agencies' liability.

We should be careful, therefore, not to underestimate the importance credit rating agencies still play even under the new regulations.

1.2 CRA Regulation in Europe 2008–2011

By the end of 2008, the credit crunch that originated in the US had evolved into a global financial crisis, leading to plunging stock markets and undermining investor confidence around the world. Having recognized the role CRAs had played in the financial turmoil, and more recently in the European sovereign debt crisis, the European Union has taken a series of steps towards designing a CRA regulatory framework. This section (see exhibit 1.2.1 and 1.2.2) is dedicated to the major CRA regulatory developments in Europe.

1.2.1 EU passed Regulation (EC) No. 1060/2009 on credit rating agencies

On April 23, 2009, the European Parliament and European Council approved the proposals on credit rating agency regulations submitted by the European Commission in November 2008, thereafter referred to as Regulation (EC) No 1060/2009. The new rules, which came into force on Dec 7, 2010, are designed to promote high quality credit ratings, by ensuring better management of conflicts of interest, more cautious methodologies and greater transparency. The passage of the proposal marked the transition of CRA regulation from a self-regulatory to a government-regulated framework in Europe. Prior to the enactment of this act, the major CRAs had opted for self-regulation under the Code of Conduct Fundamentals for Credit Rating Agencies designed by the International Organization of Securities Commissions (IOSCO) on a voluntary basis, which is not legally binding. The main provisions in this law are summarized below:[7]

Registration and supervision of CRAs: Credit Institutions may only use ratings which have been issued by recognized External Credit Assessment Institutions (ECAIs) to determine the risk weights and the resulting capital requirement applied to a bank or investment firm's exposure. These ECAIs are credit rating agencies that are registered within the EU or meet certain equivalence and criteria. Furthermore, usage of credit ratings is restricted for regulatory purposes but not for wider purposes. All the registered CRAs are subject to supervision by the Committee of European Banking Supervisors (CEBS).

Rating structured finance: The act also sets more stringent requirements for the issuance of credit ratings for structured finance, and stipulates that CRAs must create a special symbol to distinguish structured products from other rating categories.

Equivalence and Endorsement: Since the European rating industry is dominated by the three American CRAs, the act also establishes a mechanism for recognizing ratings assigned by CRAs outside the European community. Essentially, registered CRAs can endorse the ratings given by their affiliates outside Europe — provided that certain requirements are met.

The new CRA regulation has put CRAs in Europe under closer supervision, in spite of their strong objections. On June 2, 2010, the European Commission put forward proposals to amend Regulation (EC) No 1060/2009, partly prompted by the role played by CRAs in the European debt crises. This amendment is said to be the final push to complete the EU's financial services reform[8]. The amendment was approved and finally signed into law at the beginning of June 2011. The new rules come into force as of July 2011.

1.2.2 Amendment to Regulation (EC) No. 1060/2009 — Regulation (EU) No. 513/2011

The amendment aims to ensure the efficient and centralized supervision of CRAs at the European level, to enhance the quality and transparency of rating activities and to better protect investors. The main points of the amendment are summarized below:

Information disclosure for rating of structured finance instruments: Issuers are required to provide the appointed CRA with access to a password-protected website to retrieve all information necessary for the CRA to initially determine or monitor the credit rating of a structured finance product. A third-party CRA can request access to this website provided that it meets certain requirements.

A central single regulatory body: The amendment proposes transferring the registration, supervision and enforcement powers from the Committee of European Securities Regulators (CESR) to the European Securities and Markets Authority (ESMA), the new pan-European financial regulator which is to be established under the new proposals. The ESMA will be entrusted with exclusive supervisory powers over CRAs registered in the EU, including the European subsidiaries of well-known CRAs such as Fitch, Moody's and Standard & Poor's. The new regulatory body will also have powers to request information, to launch investigations, and to perform on-site inspections. Issuers of structured finance instruments such as credit institutions, banks and investment firms will be required to provide all other interested CRAs with access to the same information they give to their own CRA, in order to enable them to issue unsolicited ratings. With only one centralized supervisory authority — ESMA — being responsible for their registration and supervision at EU level, the CRAs will operate in a much simpler supervisory environment and have easier access to the information they need. Users of ratings should also be better protected as a result of centralized EU supervision of all CRAs. ESMA will also be responsible for the endorsement of the 'as stringent as' test for ratings produced by credit rating agencies outside the EU. This new rule requires that so-called third country (non-EU) CRA be subject to requirements established by law which are 'as stringent as' those applicable in the EU. For instance Japan's regulatory regime has been identified as equivalent to EU regulation. On the other hand, for US CRAs no formal 'equivalence' decision has been made so far. The ESMA will begin its role as supervisory body for CRAs in Europe as of July 1, 2011. At the beginning of June 2011, the regulation providing for its role in this regard — 'Regulation (EU) No. 513/2011' — was published in the official Journal of the European Union.

Some commentators from the Wall Street Journal responded to the announcement of the proposed amendments by raising doubts as to whether this tightened scheme would enhance the competition and eliminate the rating oligopoly of the Big Three. There are concerns that, under the more stringent requirements set by the regulators, there would be fewer raters. Regarding the rule of giving all interested raters access to the issuer dataset, Stefan Kolek, a strategist at UniCredit Spa in Munich, said: “This seems to be missing the point. It does not address the need to reform the rating agencies’ business model.”

The CRAs have not initiated any major moves following the announcement of the proposed amendment. Martin Winn, a spokesman for Standard & Poor’s in London said in a statement “the new EU regulations will play an important part, alongside the measures Standards & Poor’s has taken independently, in building market confidence and integrity and transparency of ratings.” The spokesman for Moody’s, Daniel Piels, said Moody’s Investors Service “will continue its constructive dialogue with European regulators and policy makers on initiatives contributing to enhanced confidence in the quality and transparency of credit ratings globally.” Julian Dennison, spokesman for Fitch Ratings, said that his agency “supports fair and balanced oversight and registration of credit-rating agencies and has been closely engaged in constructive dialogue with the European Union.”[9]

The new EU rules on CRAs are intended to help Europe strengthen its financial system and prevent future crises. In contrast to the US, the European Commission reacted to the global financial crisis by supervising agencies more closely, rather than by excluding references to their ratings in regulations. For regulatory purposes, the Commission will now only use the ratings of registered CRAs. However, in 2011, the EC has become more critical of the overreliance on CRAs. The EC warns that new registration requirements may lead to a false sense of security and stresses that the ratings should always be scrutinised thoroughly.

1.3 CRA Regulation in Asia-Pacific 2008–2011

In response to the regulatory developments in the US and Europe, many Asia-Pacific economies have signaled or already taken action to strengthen the regulatory framework governing their credit rating agencies. As the international financial market becomes increasingly globalized, it is essential for Asian economies to establish rules comparable to those in force in the US and Europe. Specifically, as bond markets in Asia become more open and more developed, their bonds must be rated using equivalent standards. This section will highlight some important regulatory developments in the Asia-Pacific region. As there is no pan-Asian set of rules, we will discuss the individual regulation of some important Asia-Pacific economies below (see exhibit 1.3.1 to 1.3.6).

1.3.1 Australia — ASIC announces new credit rating agency rules[10]

In November 2009, the Australian Federal Government passed new regulations regarding CRAs, in an effort to put them under closer scrutiny and to limit the investors’ over-reliance on ratings as the single gauge of credit risk.

The new regulations proposed by the Australian Securities and Investments Commission (ASIC) removed the exemption that protected CRAs from liabilities that might arise from having their ratings published in prospectuses, disclosure statements, and take-over documents. This move aims to hold the CRAs more accountable and to force them to perform with due diligence in their rating process. Furthermore, since the start of 2010, CRAs must hold an Australian Financial Service (AFS) license to provide rating services. To keep the license, the CRAs will have to manage conflicts of interest, have resources that match the “scale and complexity” of their business, and have risk management systems.

ASIC also requires that issuers obtain the consent of CRAs for the inclusion of their ratings in official documents, so that the CRAs have better control over how their ratings can be used. Issuers of financial products who do not have the consent of CRAs for such an inclusion may still quote CRAs' ratings in their documents; however, the law would protect the CRAs from being liable for their rating under such circumstances. Moreover, the new regulations require that CRAs apply for separate licenses for the wholesale and retail sectors. CRAs also have to resolve any dispute with retail investors through a financial ombudsman for the credit rating they provide investors.

In response to this new rule, Standard & Poor's, Moody's and Fitch took the drastic step of quitting the retail market by withdrawing their application for the retail AFS license in early 2010.

The reason why Standard & Poor's halted their application for the retail AFS license was said to be their concern over the scheme to make it compulsory to resolve disputes with retail investors externally. John Bailey, Standard & Poor's managing director in Australia and New Zealand, said: "In terms of requirements for a retail license, we are concerned that membership of a local External Dispute Resolution (EDR) scheme would interfere with the analytical independence of our rating opinions and undermine the global consistency and comparability of ratings." Mr. Bailey also expressed a concern that the EDR scheme could change the substance of a rating and result in the creation of dual credit ratings — an Australian "EDR" domestic credit rating and a "rest of the world" credit rating — "because the local ombudsman would effectively be second-guessing S&P's analyst" which could ultimately create confusion among investors and harm the financial market. He also added that "an EDR scheme could also require credit rating agencies to disclose information that is commercially confidential and proprietary, to third parties." However, the credit rating agencies may have difficulty restricting retail investors from accessing credit information since it still offers services to wholesale investors. Standard & Poor's credit ratings ceased to be available to Australian retail investors as of January 1, 2010.

As to the impact of this withdrawal, some observers commented that it would slow down the development of the retail market in Australia, which is considered relatively small yet attractive for small investors and self-managed pension funds. Steven Wright, managing director of RBS Morgans, said that while retail investors would not lose interest in bonds and hybrids, complications might emerge for non-financial companies in borrowing more cash.[11] Mark Bayley, a credit analyst with Aquasia, said that if the rating is taken out of the market, the expected result will be deterioration in the standard of information and creditworthiness of an investment because, for retail investors, the rating is one of the few risk indicators they can refer to. Group Treasurer of Fairfax Media Ltd., Dale Bridle went so far as to say that the inability to utilize a credit rating across all debt markets potentially restricts the ability to continue to diversify sources of debt finance, which is not the intention of the ASIC.

On June 1, 2011, the ASIC released a consultation paper relating to the form and content of the compliance report which covers the quality and integrity requirements that each Australia's CRA should meet. The ASIC called on the industry to make representations before July 2011 ahead of the implementation of the proposals, which also cover conflict of interest, transparency and timeliness of rating disclosure. Eventually the new rules should help boost the integrity and standards of Australia's financial system.

1.3.2 India — SEBI enacts guidelines for credit rating agencies

CRAs in India are primarily regulated by the Security and Exchange Board of India (SEBI). Since 1999, SEBI has been entrusted with the power to oversee all matters pertaining to the operations of CRAs, such as conflict of interest, transparency and disclosure of information, as well as rating quality and integrity. In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for CRAs. Apart from SEBI, there are other regulatory bodies governing the operations of CRAs, such as the Insurance Regulatory and Development Authority (IRDA), the Pension Fund Regulatory and Development Authority (PFRDA) and the Reserve Bank of India (RBI). The specific regulatory functions of each body depend on the type of rated products concerned.[12]

On May 4, 2010, the SEBI announced further CRA guidelines on matters including transparency and disclosure, conflict management and documentation, which would reinforce the existing CRA regulatory framework in India. Under the new guidelines, CRAs are required to enhance the transparency of their rating activities by disclosing their compensation arrangements with issuers, the default rate on their previous ratings, and their shareholding patterns. In the case of unsolicited ratings — ratings not arising out of an agreement between an agency and the issuer — the credit rating symbol would be accompanied by the word ‘unsolicited’. For structured products, CRAs have to disclose the track record of the originator and details of the nature of the underlying assets when assigning the credit ratings. Furthermore, rating agencies would have to disclose the performance of the rated pool at least once every six months. The guidelines also contain provisions on other issues apart from disclosure, for example on the prohibition of advisory service provision, and on documentation of the rating process. The SEBI required that CRAs complied with the guidelines by June 30, 2010 and make mandatory disclosures at least twice a year.[13]

In tandem with the recent regulatory developments in the US and Europe, SEBI announced in September 2010 that it is contemplating further regulatory changes to tackle the “rating shopping” menace which has arisen from the issuer-pay business model.

The current regulations in India give issuers the option to accept or reject any rating assigned by CRAs. While the accepted ratings are disseminated by CRAs, the rejected ratings are kept confidential. In an effort to curb “rating shopping”, SEBI is considering to make it mandatory for CRAs to disclose all issued ratings, regardless of their acceptance or rejection by their clients. Other measures being considered include: allowing CRAs to offer unsolicited ratings, asking the companies to get themselves or their securities rated by two or more competing agencies, and enhancing disclosure on the relationships between CRAs and clients. However, in their disclosures, CRAs have to state clearly whether the ratings are accepted or rejected by issuers and whether they are solicited or unsolicited.

In the past, some market players were concerned that mandatory disclosures of all ratings might cause issuers to avoid those CRAs with reputations for being uncompromising. However, it was subsequently recognized that compulsory dissemination of rejected ratings would protect investors and help conscientious CRAs gain in the long run, as the market would eventually reject the CRAs which were prepared to compromise on quality.

To address the conflict of interests inherent in the issuer-pay model, SEBI may also require CRAs to completely separate their analytics and business development teams. Disclosures of relationships between CRAs and their clients could also be further enhanced.[14]

In August 2010, SEBI announced that, in addition to regulatory changes, it was considering to set up a central database of defaulters as a one-stop reference point for all types of market participants including brokerages, mutual funds, merchant banks, portfolio managers and rating agencies. The move would make it easy for any market intermediary to identify a client, person or institution that had defaulted in the past, and thus avoid doing business with the party.

The defaulter database would cover all segments of the capital market and would be built with informational support of Credit Information Bureau India Ltd (CIBIL), which retains information about all commercial and consumer borrowers in the country for the benefit of banks and other lending institutions. In addition, SEBI would ask all market participants to contribute the names and details of their individual defaulters to this common database, for the benefit of other users. It is also proposed that SEBI makes it mandatory for every intermediary to subscribe to such a database and update the database with the details of defaulting clients so that other intermediaries may refer to the database before entering into any relationship with a new client.[15]

1.3.3 Hong Kong — SFC plans to introduce regulatory regime for CRAs in Hong Kong

On July 19, 2010, Hong Kong's financial regulator, the Securities and Futures Commission (SFC) announced plans to tighten the legislation governing CRAs in order to meet new standards set by the European Union and other overseas jurisdictions. Starting in July 2011, the European Union will prohibit any credit rating issued by a non-EU agency, unless it operates within a regulatory regime that is deemed equivalent to or as stringent as the EU regime. Hence, if credit ratings issued by CRAs based in Hong Kong are to continue to be serviceable in Europe, it is essential for the SFC to develop a compatible regulatory regime. Following a public consultation exercise that they conducted in the second half of 2010, the SFC announced on April 21, 2011 that it would license and regulate credit rating agencies (CRAs) and their rating analysts from June 1, 2011. In anticipation of the new regulations, parties intending to provide credit rating services on or after June 1, 2011, must submit applications to the SFC for a licence.

The proposed rules are intended to ensure CRAs activities are in compliance with principles of integrity, transparency, responsibility and good governance. The code of conduct in the proposal consists of four major elements: Quality and Integrity of the Rating Process, Independence and Avoidance of Conflicts of Interest, Responsibilities to the Investing Public and Issuers and Disclosure of the Code of Conduct and Communication with Market Participants.[16] In addition, the SFC has proposed a regime that would subject both the credit rating agencies and their analysts to licensing requirements. The proposal will designate "providing credit rating services" as a new type of regulated activity under the Securities and Futures Ordinance, and would involve ongoing supervision in a similar manner to existing SFC licensees.[17]

The further regulation and licensing of credit rating agencies will bring Hong Kong's regulatory regime in line with international developments in this area.

1.3.4 Japan — FSA revised Financial Instruments and Exchange Act[18]

In an effort to keep in step with the regulatory developments in other developed economies, the regulators in Japan introduced several provisions governing CRAs under the amendment to the Financial Instruments and Exchange Act, which was enacted on June 17, 2009 and came into effect on April 1, 2010. The amendment will only serve as a supervisory framework for registered CRAs. CRAs with a well-established operational control system in place can obtain their registration from the Prime Minister through a newly introduced mechanism. Foreign corporations are required to establish a base in Japan. The regulation has thus established registration requirements similar to those in the US and Europe.

Under the new provisions, CRAs are required to secure personnel who have sufficient expert knowledge and skills, to ensure the quality of information used in credit rating activities, to examine the validity and effectiveness of rating determination policy, and to monitor and keep track of rating changes. CRAs also have to conduct a regular rotation of credit rating analysts as well as establish a supervisory committee consisting of external members, whose purpose is to prevent conflicts of interest, ensure compliance and resolve complaints. They are required to disclose information related to the rating process on a timely basis. In addition, they are prohibited from engaging in activities such as name lending, concurrent provision of rating and consulting services, provision of ratings to closely related persons, and allowing credit analysts to receive money/goods from issuers.

Further to this, on June 1, 2011 the Financial Services Agency of Japan (FSA) and the European regulatory body ESMA exchanged letters regarding the supervision of and sharing of information about

Credit Rating Agencies. The purpose of this 'Exchange of Letters' (EOL) is to establish a mechanism for cross border cooperation on CRAs. The EOL with Japan is the first cooperation agreement signed between Europe and a supervisory authority from a so-called third country. It reflects the progress that is currently being made in ensuring the effective supervision of CRAs at an international level.[19]

1.3.5 Philippines — Establishment of a Central Credit Information Corporation[20]

In April 2010, the Philippine government established the Central Credit Information Corporation (CCIC) under the provisions of the Credit Information System Act (CISA). This is a remarkable effort by the Philippine regulators, since the idea of CCIC was first introduced in 2009 when the CISA was finally passed by the government after being put on hold for almost two years. The credit bureau was expected to be in operation by the end of 2010 but the lack of a president still stymies the CCIC's operations and the Philippines is still waiting for final implementation.

The CCIC will be the country's first credit information bureau and is expected to pave the way to faster processing of loans or claims as it centralizes, in a database, the credit history of individuals and companies. The Governor of the Central Bank of the Philippines, Amando M. Tetangco Jr. said, "The recent passage into law of CISA will definitely help. Unlike the present situation where credit information is privately generated, the ensuing credit bureau will make credit information publicly available. This alone levels the field because similar decisions can now be made using common information."[21]

The bureau will help all types of banks, non-bank financial institutions, credit card companies, insurance companies, and other financial institutions to determine the creditworthiness of borrowers with greater efficiency. According to Nestor Espenilla Jr., the deputy governor of the Central Bank of the Philippines "A credit bureau will help banks price risk better. The cost of doing business will also be rationalized in the process." With access to this central database, CRAs may gain better information with which to assess the risks of lending to companies.

In term of organizational structure, 60% of CCIC is controlled by the National Government, with the remaining 40% owned by qualified private investors such as banking industry associations, quasi-banks, other credit related associations and associations made up of consumers.

1.3.6 Singapore — The Monetary Authority of Singapore has released a consultation paper on the proposed regulation of CRAs locally

In an attempt to ensure Singapore remains an attractive location for rating agencies to operate in, the Monetary Authority of Singapore (MAS) released a consultation paper on the proposed regulation of CRAs in March 2011. The new regulations on CRAs operating in Singapore are being proposed to conform to international standards and practices. CRAs will be required to be licensed under the Capital Markets Services (CMS) licensing regime. This requires CRAs to comply with existing regulations, guidelines and notices made under the Securities and Futures Act. In addition, a Code of Conduct for CRAs is being proposed that is largely based on the IOSCO Code of Conduct Fundamentals for CRAs. It is noted that the Code is non-statutory, and non-compliance with the code will not subject licensees to criminal liability. However, failure to comply with the Code will be taken into account by MAS in determining whether the licensee can remain licensed.[22]

The above clearly shows that regulatory authorities worldwide are attempting to overhaul current CRA regulations. In the context of globalization, a coherent and consistent legal environment can only be achieved with the contribution and co-ordination of all economies. With that in mind, the next section will discuss how non-regulatory parties are reacting to the challenges faced by the credit rating industry.

II. NON-REGULATORY RESPONSES

In addition to the regulatory overhaul, both governmental and non-governmental entities have offered a number of non-regulatory responses to the problems detailed above. As it is not possible to discuss all initiatives, the next paragraphs discuss some examples that highlight the recent trends in this respect.

2.1 Issuer — Pay Credit Rating Agencies

2.1.1 International Rating Agencies

Following widespread criticism of credit rating agencies' role in precipitating the global financial crisis, the three major international rating agencies — Standard & Poor's, Moody's and Fitch — have each announced plans to overhaul their rating processes (see exhibit 2.1.1.1).

2.1.1.1 Responses by Credit Rating Agencies

In January 2009, former Ernst & Young Chief Executive Officer Ray Groves was appointed as the ombudsman for S&P, in an effort to address potential conflicts of interest and to boost transparency. The establishment of an ombudsman's role is part of S&P's 27-step plan, announced in February 7, 2008, to strengthen their rating process in areas of governance, analytics, information, and investor education. Other measures that have been undertaken by S&P as part of the reform plan include: periodic rotations of analysts and separation of compliance, quality control assurance, and other functions from the analytic teams, as well as partnering with New York University Stern School of Business and American College Testing (ACT) for its Credit Analyst Certification Program.[23] At the announcement of the 27-step reform plan by S&P in January 2008, New York State Attorney General Andrew Cuomo stated that "Both S&P and Moody's are attempting to make piecemeal change that seem more like public relations window-dressing than systemic reform" and pledged to continue investigating their roles in the mortgage crisis.[24] In January 2009 when Mr. Groves was appointed as the ombudsman of S&P, Sean Egan, managing director of Egan-Jones Ratings Co, which is a credit rating agency where investors rather than issuers pay for ratings, described the action as window-dressing and stated that "the fundamental problems with issuing timely, accurate ratings remain — unsound ratings have been a major contributor to the economic downturn we're in."[25]

In November 2009, Moody's published a special comment on the rating reform initiatives that it has undertaken in the past two years. The specific measures include separating the surveillance function from the initial rating function in the structured finance group, enhancing disclosures of rating methodologies and performance and strengthening measures to curb conflict of interests.[26]

On February 5, 2009, Fitch released a report summarizing the key initiatives the agency had undertaken to enhance the reliability and transparency of its credit ratings. This update supplements Fitch's May 2008 commentary.[27]

2.1.2 Domestic/Regional Rating Agencies

Given the role of the major CRAs in the global financial crisis, but also in the recent Greek Debt Crisis, the lack of competition in the rating industry has been widely acknowledged and the idea of creating a domestic credit rating agency has recently gained much attention in Europe as well as other regions. Having recognized the immense influence that CRAs can wield on the national/regional economy, many European political leaders have voiced their concerns over the oligopoly in the credit rating industry, and proposed the creation of a European credit rating agency to compete with the existing Big Three (see exhibit 2.1.2.1).

2.1.2.1 Proposal of an EU-backed Rating Agency

German Chancellor Angela Merkel said on May 3, 2010 that a European rating agency "could be useful" in the wake of the Greek debt crisis, along with "possible changes" to the EU stability and growth pact.[28] Similarly, Michel Barnier, the EU internal market commissioner with responsibility for the financial services sector, expressed concern over the way in which Greek debt was handled and stated that there should be more competition and diversity in rating agencies. The creation of a new Europe-based rating agency that specializes in sovereign debt could help resolve that problem. Officials said later that the commission's thinking in this area was still at a very early stage.[29]

On June 1, 2010, Luxembourg Prime Minister Jean-Claude Juncker, who heads the group of euro-area finance ministers, called for the creation of a European ratings company overseen by the European Central Bank. European Commission President José Manuel Barroso said on the following day that he was considering a similar proposal. On the same day, Christian Noyer, French central bank governor and an ECB Governing Council member, stated that the ratings companies had aggravated the crisis by making untimely risk assessments that were overly influenced by markets.

Although many political leaders have mentioned a European rating agency, the idea remains a vague one, since EU officials have not yet reached a decision on how such a company would be funded or where it might be based. There are also concerns that the proposed government-sponsored rating agency could have difficulty in establishing its credibility in the market.

Investors such as Toby Nangle at Baring Investment Services Ltd have suggested that a government-established credit assessor might have difficulty in convincing bond-buyers that it was not shielding euro-region nations such as Spain and Portugal from scrutiny as countries struggle to cut their budget deficits. Laurent Bilke, a former ECB economist who now works for Nomura International Plc in London, was quoted as saying that the problem was not setting up a European rating agency but getting the investment community to follow it, particularly if such an agency issued ratings for sovereigns. For sovereign ratings, the rating agency would have to be strictly independent from both fiscal and monetary authorities.

In Asia, there are concerns that the ratings by the Big Three are not independent and may fail to reflect trends specific to Asia. In June 2011, senior industry figures from Asia called for a joint effort to develop an internationally recognized rating agency to compete with Moody's, Fitch and S&P. They stress that financial markets would greatly benefit from a different point of view as currently the big three agencies are not being challenged sufficiently and are too US-centric[30] (see exhibit 2.1.2.2). However, the discrepancies in rating scales among different countries have slowed progress in this direction, despite the presence of domestic rating agencies in most Asian economies.

2.1.2.2 Proposal of an Asian Credit Rating System[31]

Datuk Seri Nazir Razak, group chief executive of CIMB Group, pointed out in June 2009 that years of Western domination of finance has created an inherent systemic bias that impedes the progress of Asian banks. Mr. Nazir expressed that he could not understand the basis of China, the world's largest lender, being rated A1 by Moody's compared to AAA for the UK and AA2 for Italy. Many observers have argued that beyond rising deficits, rating agencies should have taken into account a country's current account and trade account surpluses, international reserves position as well as levels of external debt.

Given the overreliance on these global rating agencies, Mr. Nazir suggests establishing an Asian-owned and managed rating agency. However, according to Malaysian Ratings Agency Corporation's (MARC) chief rating officer Milly Leong, rating agencies in different nations have different rating scales and these may not be comparable. She also commented that though each domestic rating agency had a different scale, it would rank its own government at AAA and the rest accordingly after that.

Ms. Leong stated that while credit agencies in Asia were working to bring their rating standards and methodologies closer, convergence would take a long time.

In China, the role played by the Big Three in the recent crises have led to public concern over the potential impact of US-based credit rating agencies on the national economy. Since the onset of the Greek debt crisis, there have been increasing calls to strengthen domestic credit agencies in order to gain effective control of domestic financial stability (see exhibit 2.1.2.3 and 2.1.2.4).

2.1.2.3 China Must Strengthen its Rating Agencies[32]

Experts say China needs its own successful credit rating agencies to have greater international pricing power, as increasingly more Chinese firms are listed in foreign markets and a significant portion of the country's foreign exchange reserves are invested in overseas financial assets. It is alleged that the Big Three have captured over 60% of the Chinese credit rating market through acquisitions of domestic rating agencies.

Xiang Songzuo, Deputy Director of the Center for International Monetary Research at Renmin University of China, believes that countries other than the US should develop their own credit rating agencies in order to reduce the Big Three's dominant price setting power for securities and other financial assets.

However, Xiang recognizes that to gain equivalent credit rating influence, China's financial markets and currencies must be strong enough to compete with Wall Street and the US dollar. This "involves an improvement of our legal system and accounting system to build the Chinese financial sector into a world-class one," according to Xiao Geng, director of the Brookings-Tsinghua Center for Public Policy.

One of the many challenges that Chinese CRAs currently face is documented in exhibit 2.1.2.4 below.

2.1.2.4 China Rating Agency Condemns Rivals[33]

On July 11, 2010, Dagong Global Credit Rating, a privately-owned credit rating agency based in China, published a report containing its own sovereign credit ranking. The report covers 37 countries in Europe and Asia, eight countries in South America and North America, three in Africa and two in Oceania. These 50 countries collectively account for 90 percent of the world's GDP. Dagong's results were very different from those published by Moody's, Standard & Poor's and Fitch, with China ranking higher than the United States, Britain, Japan, France and most other major economies, reflecting Dagong's belief that China is more politically and economically stable than all of these countries. The ranks for other BRIC nations, which comprise Russia, Brazil and India, are also higher than those issued by the three dominant agencies.

Guan Jianzhong, the chairman of Dagong, said the company's methodology had been developed over the last five years and reflects a more objective assessment of a government's fiscal position, ability to govern, economic power, foreign reserves, debt burden and ability to create future wealth. "The US is insolvent and faces bankruptcy as a pure debtor nation but the rating agencies still give it high rankings," Mr Guan said. "Actually, the huge military expenditure of the US is not created by themselves but comes from borrowed money, which is not sustainable."

As the first credit rating agency other than the three dominant agencies to release sovereign credit rating reports, Dagong has provoked intense debate about its credibility. Sun Lijian, a professor at the China Center for Economic Study at Fudan University, commented that this first step by Dagong would yield beneficial results, as China has experienced the harmful monopoly of Fitch, Standard & Poor's and Moody's. However, Cui Xinsheng, a professor with Beijing Institute of Technology, expressed concern that the report contained too many irrational factors and the results would not be adopted by investors in other countries.

In September 2010, the US Securities and Exchange Commission (SEC) denied Dagong's bid to become an NRSRO in the US, claiming that "It does not appear possible at this time for Dagong to comply with the record-keeping, production, and examination requirements of the federal securities laws." In response to the denial of its application, Dagong released a statement on September 25, condemning the SEC for rejecting its application as they are unable to handle cross-border regulation and oversight. The firm said that the SEC is discriminatory against Chinese credit rating agencies and the company is considering legal action against the SEC.

In its statement, Dagong also emphasized the significance of having a Chinese credit rating agency in the US to safeguard China's overseas financial assets, not least because China is the largest creditor of the US and currently owns huge amounts of financial assets in the country. Dagong is the first firm to be denied by the SEC since the regulations governing the application process went into effect in 2007.[34]

More recently and in spite of the SEC's denial, the Chinese CRA seems to be getting more exposure in financial markets.

2.2 Investor-Pay Credit Rating Agencies

Since the onset of the global financial crisis, there has been widespread criticism of the conflict of interests inherent in the issuer-pay model adopted by the dominant credit rating agencies — Moody's, S&P's and Fitch. Given the public outcries over issuer-paid ratings, some smaller investor-pay rating agencies have seen strong demand growth potential due to investor preference towards unbiased ratings and have taken this opportunity to expand their business.

2.2.1 Morningstar Bought Credit Rater Realpoint[35]

On May 3, 2010, Morningstar, a Chicago-based investment research company, completed the acquisition of Realpoint, an investor-pay boutique rating agency that specializes in ratings of Commercial Mortgage-Backed Securities (CMBS). Despite an employee base of only 43, Realpoint was designated a Nationally Recognized Statistical Rating Organization (NRSRO) in 2008 and has more than 225 institutional subscribers, including the majority of money managers who invest in commercial mortgage-backed securities. As Morningstar has about 2,600 employees worldwide, Rob Dobilas, president and chief executive of Realpoint, commented that the merger added to the credibility of its ratings, by removing any concerns about the size of the company.

Morningstar announced in December last year that it was expanding its reach beyond stock-market research by starting to publish credit ratings for nearly 100 of the largest US companies. It said it planned to produce grades for up to 1,000 firms covered by its equity analyst team.

As to the conflict of interests encountered by the Big Three, Morningstar and Realpoint said that they will avoid it because most of their ratings are paid for by investors instead of issuers. However, Fitch spokesman David Weinfurter made a different point, stating that "there are conflicts that have to be managed by credit rating agencies whether they are paid by issuers, investors, or both."

On October 4, 2010, Robert Dobilas, the CEO of Realpoint, announced that the company would significantly expand its reach in the US debt ratings business by offering investors assessments on residential mortgage bonds and other asset-backed securities. Realpoint will focus on ratings of existing residential mortgage-backed securities (RMBS) that do not carry any kind of government backing, and may start the rating by the end of the year.[36]

2.2.2 Weiss Is Returning to Ratings Business[37]

Weiss Group, LLC, a leading provider of independent research and ratings since 1971, announced on 6th May 2010 that it had bought back the bank and insurance company ratings which it sold to The Street in 2006, restoring the business to its wholly owned subsidiary, Weiss Ratings. In addition, the rating unit is in the process of application for NRSRO status.

Martin Weiss, the chairman of Weiss Group said "I believe the whole system around NRSROs needs to be reformed — that's a factor that motivated me to return to the ratings business and to demonstrate that alternatives to the popular business model are possible and better for investors."

Unlike the dominant three players in the industry, Weiss Ratings adopts an investor-pay model whereby lettered ratings issued by his firm will be publicly available, while paying investors will get access to additional services, such as more in-depth research, on the companies covered by Weiss.

2.2.3 *New China Rating Firm's Model Could Reshape Industry*[38]

In September 2010, China set up a non-profit credit rating agency, China Credit Rating Co (CCRC), to tackle conflict of interest problems inherent in current domestic rating agencies. The agency is funded by the National Association of Financial Market Institutional Investors (NAFMII), a trade group that operates under the central bank.

According to Feng Guanghua, the chairman of the new agency, CCRC will have more credibility as it has no fee-paying relationship with the issuers. Liu Shiyu, a central bank governor, said that the new firm will work to achieve independent risk assessments in credit ratings, while acknowledging that such an attempt to reform rating industry will be very difficult.

Industry experts have conflicting views of the new agency. Some commentators believe that the new agency will gradually change the current practices of rating agencies, while others say it is too early to make any conclusions.

In addition to investor-pay credit rating agencies, the big three players also face potential competition from other firms that provide credit services. The Bloomberg corporate credit rating service that was launched recently is only one example.

III. CONCLUDING REMARKS

The financial crisis has confirmed that the CRAs need to be regulated. However there is still ongoing debate about how far regulation should extend. Should CRA regulation include standardization of the ratings themselves? Should it require the CRA to disclose their rating methodology? Should CRAs be organised by region? We believe that regulation should promote transparency, governance and quality of ratings whilst further stimulating innovation and competition. We also believe that credit ratings have a strong "public good" characteristic and high-quality credit ratings can be developed and made available on a not-for-profit basis.The RMI Credit Rating Initiative, which is further discussed in this edition, tries to achieve this goal.

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