

KEY POINTS:

- Neither the International Organization of Securities Commission Code nor the existing Directives were seen by the EU as adequate in the face of the 2007 financial services firestorm.
- The scope of the European Regulation on Credit Rating Agencies ('CRAs') – ie that ratings can only be used for regulatory purposes if they are issued by a registered CRA – is a neat way of getting round the fact that ratings are essentially just opinions.
- The main concern is that the equivalence regime remains opaque – and that non-EU CRAs will be disadvantaged.

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Regulation of credit rating agencies in Europe

Both John Moody who published *Moody's Manual of Industrial and Miscellaneous Securities* in 1900, and Henry Varnum Poor who in 1860 published *History of Railroads and Canals in the United States*, to provide investors with stock reporting and analysis, would have been astounded at the legislative attentions the respective companies they established have recently received. As ratings became embedded in the world of finance, first for corporate debt and then for structured finance, they were left virtually free of any direct regulation. Even indirect regulation was almost absent until the current decade.

In Europe, credit rating agencies ('CRAs') were free of any direct regulation until this year when the EU approved the *European Regulation on Credit Rating Agencies* (the 'Regulation') to set behavioural standards for credit rating agencies, increase transparency, enhance corporate governance standards and introduce regulation and supervision (see text box overleaf for further details).

The credit rating agencies began to attract serious attention from the regulators when off-balance sheet structured investment vehicles, issues of securities backed by subprime debt, CDO-squareds and other exotic products started to implode, notwithstanding that many of these products had investment grade or even triple AAA ratings – equivalent to those of the strongest sovereign states. Because many investors argued that they had bought these products at least in part because of the ratings they had been given, and indeed both the internal and external regulations of many institutions required them to only invest in assets which attracted minimum ratings, regulators took the view that formal regulation was urgently required.

To be fair the effects of the credit crunch gave momentum to a process already under

Blamed by many politicians and commentators for contributing to the structured finance markets, credit rating agencies have been in the crosshairs of the financial regulators from the early days of the credit crunch. Now the EU has followed America's lead, by introducing the directly applicable European Regulation on Credit Rating Agencies (the 'Regulation'), which will become effective across the EU. But do the EU's new rules hit the target? Edmund Parker and Miles Bake of Mayer Brown, discuss and analyse the new regulatory environment in Europe impacting rating agencies and the development of the new regime.

way. The progressive regulation (formal or voluntary) of CRAs had been spurred on by earlier crises relating to the corporate debt of Enron and Parmalat, which had attracted high investment grade ratings prior to their spectacular failures in the early part of the decade.

The Regulation is the latest step in that process, but its impact can only be assessed against the patchwork of initiatives and codes that had built up in the last few years.

THE EU BACKGROUND

It was the Parmalat scandal back in 2004 – and a political perception amongst some that CRAs had been deficient in discovering and responding to that episode – that originally led to the European Parliament mandating the European Commission to explore whether CRAs needed regulating. The Commission called for advice from the Committee for European Banking Supervisors ('CEBS') in late 2004.

In response to CEBS subsequent advice, Charles McCreevy, the Commissioner for the Internal Market explained at the time that his Directorate was 'confident that the existing financial services Directives applicable to CRAs – combined with self-regulation on the basis of the International Organization of Securities Commission ('IOSCO') Code – will provide an answer to all the major issues of concern'.

The existing financial services directives, which Mr McCreevy referred to were:

- The Market Abuse Directive ('MAD'), which the Commission made clear applied to CRAs, and that if a CRA knew or ought to have known that its rating was false or misleading, the prohibition on market manipulation may apply.¹
- The Capital Requirements Directive ('CRD'), which sets the standards by which a CRA will be recognised as providing adequate ratings for use by banks when calculating their capital adequacy requirements; and includes a number of transparency and governance rules and procedures. These have been effectively replaced now by the standards of the Regulation.

The IOSCO Code is a voluntary CRA compliance regime built around IOSCO standards. It began in December 2004 when IOSCO published its first Code of Conduct Fundamentals for Credit Rating Agencies. It was then, as now, a series of corporate governance and transparency standards aimed at ensuring CRAs conduct their business so as to minimise the risk of conflicts of interest and other internal operations damaging the integrity and quality of their ratings. Being the product of a global organisation, the IOSCO Code is necessarily drafted as a set of high-level

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principles which can be applied to CRAs around the world.

By 2007, many of the larger CRAs, including Standard & Poor's, Moody's and Fitch were assessed to have 'substantially implemented' the IOSCO code.²

INTRODUCTION OF THE REGULATION

However, neither the IOSCO Code nor the existing Directives were seen by the EU as adequate in the face of the 2007 financial services firestorm. There has been a sea change from a world in which self-regulation and light-touch regulation were the order of the day, to one where this is now politically unacceptable, and the idea of CRAs adhering to a voluntary code is no longer seen as appropriate. Hence the Regulation was proposed by the Commission in November 2008 and approved by European parliament in April this year.

CHALLENGES OF THE 'EQUIVALENCE' REGIME

The major international ratings agencies will surely all approach the EU for registration and, given the size of the market, will also do whatever is required to obtain the necessary registration (even if the precise details of what they will have to deliver has not yet been formulated). For smaller, local CRAs based outside of the EU, the equivalence regime may pose problems. In particular, it is not clear how the CEBS will make its decisions on what is an equivalent regime. Because the Regulation goes beyond the IOSCO Code – admittedly in relatively minor governance, analyst rotation and fee disclosure respects – for a third-country CRA to have equivalent standards will involve more than simple IOSCO Code compliance. Finally, the equivalence criteria involve an evaluation by the CEBS of the

regulatory regime in the third country, which potentially means that the ratings given by third-country CRAs will be disbarred from use under the Regulation on the basis that their national regulatory infrastructure is not up to EU standards. This could limit competition amongst CRAs within the EU.

Like any new system, the registration process will take time to bed in and of necessity will be made to work, one way or another. The main concern is that the equivalence regime remains opaque, and that as a result non-EU CRAs will be disadvantaged, at least to begin with. Whilst the market impact of this taken as a whole will be small, the specific impact on certain firms could be significant.

IMPACT ON STRUCTURED FINANCE?

During the consultation period preceding the Regulation, the securitisation industry opposed adding an 'additional symbol' to the ratings of structured finance products. Whilst politicians may desire this, it is liable to confuse investors and suggest that there is some qualitative difference between structured finance ratings and the rest. For regulatory capital purposes – ie the applicable credit quality step assigned to a rating – the 'additional symbol' would not appear to make a difference (for now). Which begs the question, what does this additional symbol achieve? If the rating of a structured product is qualitatively inferior, why would this not be reflected in a lower rating itself? If it is not inferior, why do we need the additional symbol?

Ratings do not address the liquidity or mark to market values of structured securities. In the absence of this, the additional symbol serves only to highlight that the particular security is a structured security – something which should be apparent anyway.

The limitations imposed by the Regulation on analysts leaving CRAs to work for entities they rated would, we would expect, be largely irrelevant in structured finance, since the issuers of structured products (CDOs, RMBS) are typically special purpose vehicles. Surprisingly

Is the scope of the Regulation right?

The scope of the Regulation – ie that ratings can only be used for regulatory purposes if they are issued by a registered credit rating agency ('CRA') – is a neat way of getting round the fact that ratings are essentially just opinions and as such, anyone could issue them. This means that in practice they typically fall outside the majority of financial services and investment directives. It also means, as a point of English law, that it is unlikely (though not impossible) that investors would be able to initiate direct legal actions against CRAs in respect of the ratings they give.

By tying the regulation of CRAs to the use to which their ratings are put, some of the conceptual problems of trying to define a CRA with precision are sidestepped. The Regulation adopts a very wide definition of a CRA, as 'a legal person whose occupation includes the issuance of credit ratings on a professional basis' – with 'credit ratings' acknowledged as being 'opinions'. The tightness comes in the usage, as in, just for regulatory purposes (although even this is vaguer than it could be – for example, reference to specific regulations would have been helpful).

On the other hand, linking the regulation of CRAs to the uses to which their ratings are put creates the possibility of a two-tier system of ratings emerging since many ratings are not used for regulatory purposes. The Regulation clearly does not impose any obligation on investors, including UCITS (Undertakings for Collective Investments in Transferable Securities), only to invest in rated instruments. Since the CRD only applies to credit institutions, non-bank investors will not be constrained in the ratings they use.

A further gap in the scope is that, when it comes to calculating capital requirements, many of the larger and more systemically important banks calculate their capital requirements using the 'Internal Ratings Based' ('IRB') approach. That is to say, they do not rely on published credit ratings from CRAs when calculating capital. So, even if the Regulation does improve ratings, from the point of view of regulatory capital, the Regulation will only affect the banks which use the standardised approach to calculating capital requirements. The bigger, more sophisticated – and systemically important – IRB banks are unlikely to be affected.

Biog box

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these limitations do not extend to analysts leaving CRAs to work for entities arranging structured finance products.

WILL THE REGULATION CHANGE THE WAY CRAs OPERATE?

The response of multinational CRAs to the Regulation suggests that they are broadly able to carry on without major new changes. DBRS issued a press release welcoming the Regulation and the additional transparency they will bring, but at the same time pointing out that, through the IOSCO code and US NRSRO (A Nationally Recognized Statistical Rating Organization) structure, they are already closely monitored and regulated. The response of Standard and Poor's was similar: they welcomed the Regulation as a way of rebuilding confidence in ratings, but stressed that they had already strengthened their ratings process and enhanced transparency.³ What they, and others, stressed was the desire for global consistency.

GOVERNANCE IS ONE THING, GETTING THE RATINGS RIGHT IS ANOTHER

One argument used by under-fire CRAs was that their ratings only addressed the likely default of entities or instruments. This sounds simple enough but pre-crisis, investors were treating ratings as proxies for liquidity and thus for the market value of the rated instrument. They were thereby failing to conduct a rounded investment appraisal. IOSCO, in fact, explicitly made this accusation, in May 2008:

'Regulators may need to revisit policies that equate low default risk with low volatility and liquidity risk and thus encourage some market participants to rely entirely on credit ratings in place of these market participants conducting a thorough and adequate risk assessment themselves.'⁴

The Regulation alone cannot prevent misuse of ratings (and because their scope is limited to use or ratings for regulatory purposes only, they do not really try to,

although one of the recitals does enjoin users of ratings 'not to rely blindly on credit ratings').

One concern, therefore, is that if a CRA is registered and meets the EU standards, investors could place reliance on its ratings just as much as before. The fact that certain CRAs greeted the ratings as a way of restoring confidence in ratings suggests that this is the outcome they might hope for.

In practice, recent investor experience

"As CRAs set out clearly what their rating methodologies and approaches are, arrangers can structure products accordingly."

suggests that a revived over-reliance on credit ratings will not happen. But the point illustrates a tension in current regulatory thinking between, on the one hand, recognising how important credit ratings are and on the other hand attempting to wean investors off over-reliance on them (for example, in the area of securitisation, by imposing stricter disclosure and due diligence regimes on originators and investors). Currently the EU is doing both, which smacks of a belt-and-braces approach – but perhaps that is what is required?

CONCLUSION

The Regulation is the product of a response to a financial crisis which, only in part and in certain areas, could attach any blame to ratings. However, it is questionable if the Regulation would either have done much to prevent this crisis, or would prevent a future one. The three largest rating agencies were all at the forefront of implementing the then-existing IOSCO Code and were substantially compliant with it. Substantial mistakes were made by some when rating certain types of structured debt. Arguably, all the Regulation would have done would have meant that the mistakes were spotted quicker – not that they would be less profound in consequence.

Indeed, one of the reasons why markets were shocked at ratings changes is that so many structured products were designed along similar lines. So, if one such product was downgraded, all would be. Paradoxically, this is the consequence of transparency on the part of CRAs. As CRAs set out clearly what their rating methodologies and approaches are, arrangers can structure products accordingly. Hence, swathes of

imitative instruments correlated by the methodologies underlying their ratings: itself is a cause of systemic instability, but which is not tackled in the Regulation.

Could this happen again? There is no conceptual reason why it could not. Implicit in the Regulation and new IOSCO Code continues to be the view that if you get the corporate governance right and you review your rating methodologies frequently enough, ratings will be qualitatively better. That may be true up to a point. But just as the most rigorous investment analysis model can be undermined by too bullish assumptions, so the rating of any debt, structured or not, can be shown after the event to have been based on a flawed too-rosy view. The Regulation only requires a rigorous methodology, it does not attempt to second-guess the actual ratings given, and as such it will be investor circumspection and due diligence, rather than the Regulation, which determines how the market for ratings evolves over the next few years. ■

- 1 Commission Communication 2006/C59/02.
- 2 IOSCO Task Force Report, February 2007.
- 3 DBRS *Structured Finance Newsletter* 4 May 2009; Standard & Poor's press release 23 April 2009.
- 4 Technical Committee of IOSCO's Final Report on the role of Credit Rating Agencies in structured finance markets, May 2008, p 3.