

Supervision of Credit Rating Agencies: The Role of Credit Rating Agencies in Finance Decisions

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 [Keywords to Follow]

Introduction

“There are two superpowers in the world. . . the United States and Moody’s Bond Rating Service. . . and believe me, it’s not clear sometimes who is more powerful.”¹

Six months ago it would have been unthinkable to many that a giant such as American International Group Inc (AIG) would be staggering on the edge of the abyss.² Yet this is what happened when the credit rating agencies (CRAs) lowered AIG’s credit rating and AIG turned out to have entered into contracts that bind it to drastic obligations in the event of a decrease of the credit rating—the so-called “rating triggers”. AIG was deep into the trade of credit default swaps (CDS), which are not considered to be securities by supervisors and are therefore not subject to supervision. A CDS is essentially an insurance contract that is concluded in order to cover the results of default by a debtor of debt securities. The value of the CDS mainly depends on the value or the quality of the underlying securities. Ironically enough, the CRAs that had given the debt securities covered by a CDS of AIG a good credit rating are the same CRAs

that had lowered the credit rating of AIG. The CRAs lowered the credit rating of AIG when AIG turned out to have taken out insurance for securities that proved to have less value than the market, including the CRAs, had expected. The problem is of course that the expectations of the market with regard to those securities and the CDS market connected with it are also formed by the good credit ratings issued by the CRAs.

It will be clear that the credit rating industry is a special branch. At the moment there are only three big players in the credit rating industry: Standard & Poor’s, Moody’s and Fitch. The big three CRAs have obtained a strong market position, especially after 1975. After 1975, the market for credit ratings (also called “ratings”) boomed, as have the profits that were gained by CRAs. An important reason for this was the official status that the big three CRAs received, mostly through the American Government. Starting from 1975, the big three CRAs received the status of Nationally Recognized Statistical Rating Organization (NRSRO) in the United States. The granting of the NRSRO status also gave CRAs more influence on corporate and finance decisions. It appeared during the Enron crisis that the influence of the CRAs on corporate and finance decisions could also have perverse consequences. The call for fundamental reform within the credit rating industry only came after the Enron crisis had materialised. After the Enron crisis, the American Congress introduced the Sarbanes-Oxley Act of 2002, in which an investigation into the role of CRAs in the Enron crisis was ordered. This accelerated reforms within the credit rating industry. The result was the Credit Rating Agencies Reform Act of 2006, which instructed the Securities and Exchange Commission (SEC) to provide rules for the supervision of CRAs. During the recent credit crisis, in which the structured finance market sank to an unprecedented low, the CRAs also found themselves in the centre of attention of national and international supervisors.

This article aims to answer the question of what the role of CRAs in corporate and finance decisions is and should be. The subquestion as to what the role of CRAs in corporate and finance decisions should be is illustrated in this article, especially with the help of the normative framework that is created or will have to be created by legislative oversight and supervision. Supervision legislation in the European Union is also in order because the civil-law liability of CRAs offers insufficient realistic tools for the protection of investors, the financial markets and enterprises. This article is organised as follows. In the first section, I will answer the question what CRAs are. In the second section, I will answer the question what the role of CRAs in the Enron scandal has been. In the third section, I will answer the question what the CRAs role is during the current credit and financial crisis. In the fourth section, I will indicate the consequences of the crises to the credit

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1. “The News Hour with Jim Lehrer: Interview with New York Times” Thomas L. Friedman (PBS television broadcast, February 13, 1996).

2. cf. “AIG has used much of its \$123B bailout”, *Washington Post*, October 24, 2008, p.D01.

rating industry. Finally, in the conclusion I will give a summary and an evaluation.

What are credit rating agencies?

Credit ratings first came up in the beginning of the 20th century. In the year 1900, John Moody established his company John Moody & Company (Moody's) and published his manual *Moody's Manual of Industrial and Miscellaneous Securities*.³ As of 1909, Moody's decided also to give an opinion or "rating" of the quality of the debt securities of an enterprise compared to those of other enterprises.³ In that same period, other companies also began to publish credit rating manuals. The most important are Standard & Poor's Ratings Services (Standard & Poor's) and Fitch Ratings Ltd ("Fitch"). Standard & Poor's has been active since 1916 in assessing bonds and is part of The McGraw-Hill Companies Inc.⁴ Fitch Ratings is an American company by origin that has been active since 1924 in assessing bonds; after various mergers, it is now part of the French Fimalac group⁵

What is important is that the big three CRAs are characterised by the fact that in 1975 they received the official status of NRSRO from the SEC. This was important because the concept of NRSRO would be incorporated into various financial laws and regulations. Another characteristic of the big three CRAs is that in the 1970s they changed from a "subscriber-pay" model to an "issuer-pay" model. This means that investors no longer buy manuals and/or ratings from CRAs, but that the enterprise issuing the securities (the issuer) must pay for the ratings of CRAs. The main reason for this change of policy in the rewards system of CRAs was that it became ever cheaper for investors to make copies of the manuals containing the credit ratings that were published by CRAs. Another, not immaterial, incidental circumstance is that since 1975, since the time when CRAs were allowed to call themselves NRSRO, enterprises suddenly had a much *greater* interest in obtaining an "investment grade" rating from an NRSRO. Only NRSROs could give an investment grade rating to the securities of enterprises that could be purchased and/or held in the opinion of supervisors by institutional investors (mostly "mutual funds"), banks, insurers and (lower) public authorities. This way official CRAs may issue "licences" for supervisory purposes.⁶

Already in the 1930s of the 20th century, credit ratings were used by the US banking and insurance sector, though not yet with reference to the NRSRO status of the ratings given by specific CRAs. Credit ratings were used as objective criteria in the scope of rules related to prudential supervision, which resulted in supervisors in the banking and insurance sector to begin giving a uniform meaning to the term investment grade.⁷ From 1975, the concept of investment grade got a different meaning, because an investment grade rating was only useful if it came from an NRSRO.

A CRA would obtain an NRSRO status by a written application to the SEC. The application by the CRA for an NRSRO status was a so-called "no-action letter" and meant that the SEC promised in writing that it would not initiate enforcement in the event that "broker-dealers" deviated from rules with regard to the net capital to be preserved, if they held securities having an investment grade rating from an NRSRO-CRA. The criteria on the basis of which the SEC assessed the application for an award of an NRSRO status were not public, with the exception that the SEC considered it important that the applicant CRA enjoyed a national reputation among the users of the credit ratings. The SEC granted a similar promise when the ratings of the applicant CRA were regarded as ratings of a CRA with a national reputation.

After the CRA obtained the status of NRSRO, this had advantages for broker-dealers too, who traded in securities with an investment grade rating granted by the NRSRO-CRA. Broker-dealers were allowed to deduct a percentage ("hair-cuts") from the net capital requirements they had to fulfil if they were trading securities with an investment grade rating of an NRSRO. This created an exceptional position for securities having an investment grade rating from an NRSRO-CRA. As of 1975, the concept and status of NRSRO would be incorporated into many other rules and laws too. Also in the European Union there are similar references to official CRAs, for example the so-called External Credit Assessment Institutions (ECAIs) in financial laws and regulations.⁸

NRSROs give information and advice to (future) investors on the creditworthiness of bond-issuing entities and specific financial products.⁹ CRAs obtain their information from public sources, such as annual reports, and through private sources, mainly directly from the management of the enterprises to be assessed. CRAs play a role in the decrease of the information asymmetry between investors and

3. See <http://www.moody.com> [Accessed February 24, 2009].

4. See <http://www.standardandpoors.com> [Accessed February 24, 2009].

5. See <http://www.fitchratings.com> [Accessed February 24, 2009].

6. See F. Partnoy, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies" [1999] *Washington University Law Quarterly* 77, 619–715.

7. See House Committee on Financial Services, "Report accompanying credit rating agency duopoly relief act of 2006" (H.R. 2990, July 7, 2006), 109–546, p.9.

8. See European Commission, "Tackling the problem of excessive reliance on ratings" (DG Market Services Document, August 2008), available at <http://www.ec.europa.eu> [Accessed February 24, 2009].

9. See on this subject W.J.H. Wiggers, *Kredietwaardigheid, Ondernemingsrecht 2005/31*, pp.84–91; with reference to the relation between a good corporate governance score and the creditworthiness of an enterprise.

enterprises, thus co-ordinating and mobilising the behaviour of investors.¹⁰ This is mostly about the concept of investment grade: a credit rating given by one of the big three CRAs above a certain threshold, expressed in a letter symbol. For Standard & Poor's this is the "BBB", for example. Many institutional investors, banks and financial institutions may only invest in securities of enterprises that have a certain minimum rating of at least investment grade, from a CRA recognised (by national standards). CRAs fulfil the position of gatekeepers, since CRAs decide whether an enterprise (or certain securities thereof) receives the rating investment grade, and thus whether that enterprise gets access to institutional investors, banks, financial institutions and (lower) public authorities. Apart from that, the investment grade rating gives a signal to other (non-institutional) investors about the creditworthiness of a certain enterprise and it plays a role in the consideration to invest in the securities of a certain enterprise.¹¹ Ratings are also important for issuers with regard to the level of interest they have to pay on their bonds.

To date, CRAs have not been successfully held liable for having failed in their ratings, for example because they granted (too) high credit ratings (with hindsight), or because the credit rating of an enterprise was wrongly decreased, which resulted in financial losses.¹² CRAs practically enjoy immunity from civil-law liability for their core activity, which is issuing credit ratings.¹³ CRAs are no part of the banking or insurance sector, so that CRAs cannot be considered to have a special financial duty of care on that basis. Furthermore, the task of CRAs differs essentially from that of accountants and analysts.¹⁴ A duty of care specific to CRAs and their ratings

has not yet been formulated clearly by the legislator and/or in case law. Moreover, CRAs work as a rule with the express reservation that credit ratings are not a financial advice (to investors) to buy or sell a certain security, and that credit ratings are only independent opinions about the creditworthiness (of the securities) of an enterprise and/or legal entity. In some jurisdictions, like the United States, CRAs are expressly excluded from prospectus liability (s.11 liability).

It is possible that CRAs will be held liable in the Netherlands for prospectus liability (through s.6:194 of the Dutch Civil Code). However, the point is that credit ratings are currently usually issued at the request of enterprises in order to get access to institutional and big investors, and are expressly not intended to serve as advice on whether or not to buy a specific product. In point 10 of Directive 2003/125 (Market Abuse Implementing Directive), for example, there is an express statement that credit ratings are not investment advice within the meaning of the Directive.¹⁵ Also in Annex I of Directive 2004/39 (Markets in Financial Instruments Directive (MiFID)), the services of CRAs are not regarded as investment advice, so that CRAs are out of reach of the MiFID in that respect.¹⁶ It is the legislator's choice and/or that of institutional and big investors to attach value to the rating of CRAs, whilst other alternative ways to assess credit risks are also available, for example with the help of the performance of (American) treasury bonds (the so-called "bond spread") and performance in the credit default swap market. Credit ratings are mainly intended to provide information about the relative creditworthiness of an enterprise, i.e. the creditworthiness of an enterprise compared to that of other enterprises. Moreover, CRAs give ratings to securities that are traded globally and are intended for anyone (having a potential interest) to take notice of: after publication, credit ratings become a public good. Ratings issued by a CRA in the Netherlands or the United Kingdom, for example, are not limited to the Dutch or UK market, but play an informative, intermediary and mobilising role for investors wherever the rated securities are traded. By their nature credit ratings are not suitable for a mere national treatment for supervisory and liability-law purposes. Furthermore, in order to protect their core activity, CRAs will rely on the freedom of speech and freedom of the press provisions. With regard to the core activities of CRAs, it is unclear if and what standard serves to protect which investors. In the proposal of the Directive of the Commission of November 12, 2008 there is an attempt to work

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10. See A.W.A. Boot, T. Milbourn and A. Schmeits, "Credit ratings as Coordination Mechanisms" [?] *The Review of Financial Studies* 19 1, 81–118, quoted by A.W.A. Boot, "Corporate finance theorie en financiële crisis in breder perspectief, Topics in Corporate Finance, No.16" (Amsterdam Center for Corporate Finance, Amsterdam, 2008), pp.10–11.

11. cf. the International Organization of Securities Commissions (IOSCO) report of May 2008: Technical Committee of the IOSCO, "The Role of Credit Rating Agencies in the Structured Finance Markets" (May 2008), available at <http://www.iosco.org> [Accessed February 24, 2009].

12. In the US a number of cases have been brought against credit rating agencies (CRAs), none of which have led to liability, mostly on the ground of freedom of speech and freedom of the press: *County of Orange v McGraw-Hill Companies Inc* 245 B.R. 151 (C.D. Cal. 1999); *Jefferson County School District v Moody's Investors Service* 175 F. 3d 848 (10th Cir. 1999); and *Pan American Corp Re* 161 B.R. 577 (S.D.N.Y. 1993).

13. Otherwise H.A. de Savornin Lohman and M.G. van 't Westeinde, "Control and liability of credit rating agencies under Netherlands law" [2006/9] *Tijdschrift voor Financieel Recht*, pp.218–229.

14. See F. Dittrich, "The Credit Rating Industry: Competition and Regulation" (Inaugural dissertation, Universität zu Köln, 2007), pp.142–146, available at <http://www.ssrn.com> [Accessed February 24, 2009]. Otherwise, R.I.V.F. Bertrams, "Rating agencies en hun aansprakelijkheid" in S.C.J. Kortmann, et al. (eds.), *Onderneming en effecten, Serie Onderneming & Recht* (W.E.J. Tjeenk Willink, Zwolle 1998), Pt.13, p.341.

15. Directive 2003/125 as regards the fair presentation of investment recommendation and the disclosure of conflicts of interest (Market Abuse Implementing Directive) [2003] OJ L/339/73.

16. See Annex I to Directive 2004/39 (Markets in Financial Instruments Directive (MiFID)) [2004] OJ L145/1. cf. European Commission, *Communication from the Commission on Credit Rating Agencies*. 2006, 2006/C59/02, available at <http://eur-lex.europa.eu>.

towards such a standard.¹⁷ No important case has been filed yet in the European Union against CRAs. That may change due to the current financial crisis.

The failure of CRAs and the absence of clear civil-law liability or market discipline and public supervision has led to measures having to be taken in the United States and worldwide to supervise CRAs (for the first time), and when present, to force up this supervision further. Apart from the failure of CRAs during the Long Term Capital Management disaster at the end of the 1990s, it was mostly the Enron crisis that caused the reforms in supervision on CRAs to gain momentum. The result was the Credit Rating Agency Reform Act of 2006, which abolished the NRSRO status altogether and instead introduced a voluntary registration system together with a supervisory framework and far-reaching measures. At the same time, the Enron crisis makes clear in what way CRAs may have a negative impact on the behaviour of bond-issuing enterprises.

What was the role of CRAs in the Enron scandal?

Enron was a company that consistently received good credit ratings from CRAs at the upper levels, up until four days before Enron filed for bankruptcy.¹⁸ As late as March 2000, Moody's gave Enron a "Baa1" and Standard & Poor's and Fitch rated Enron as "BBB+", indicating a very good credit quality. Credit ratings were important for Enron, because a good credit rating, i.e. investment grade and above, provided Enron the stability to operate and expand its trading business (in energy options). It also gave Enron the opportunity to access the capital markets to meet its liquidity needs.

Enron had repeatedly sought improved ratings by the CRAs, despite the fact that it embarked on a business that involved substantial amounts of risk. Enron had also been engaged in widespread fraud for quite a while, and it seems to have been only a matter of time before the façade would surface. In the first half of October 2000, Enron informed the CRAs of a US \$2.2 billion write-down because of accounting adjustments. Ken Lay,¹⁹ the Chief Executive Officer (CEO) of Enron, tried to reassure the CRAs that in spite of the write-down, a downgrade was not necessary, because Enron would shore up its balance sheet.²⁰ On October 17, 2001, however, the

Wall Street Journal brought the trailblazing report about Enron's off-balance sheet arrangements,²¹ and the SEC started to investigate the allegations of the report, while Enron's Chief Financial Officer Andrew Fastow resigned. This did not yet prompt the CRAs to act with regard to Enron. They would only do so when in early November 2001, reports abounded that Enron was seeking a substantial equity investor or acquirer for the company to address its liquidity problems, and that Enron had to draw down its line of credit to the amount of US \$3 billion with its banks at the end of October 2001.²² On November 5, 2001, when informed of the drawdown by Enron, Moody's and Standard & Poor's decided to lower Enron's credit rating to just two notches above "junk", while Fitch lowered Enron's rating to just one notch above "junk", i.e. investment grade, but only just.²³

Enron's business model was predicated upon an "investment grade" rating, and a downgrade to "junk" would have disastrous effects.²⁴ It would not only hamper Enron's ability to enter into agreements with counterparties in relation to its trading operations, but it would also "trigger" provisions in a number of agreements of Enron ("rating triggers") so as to constitute a default or to require cash collateral, i.e. accelerated payment. In this period, absent a proximate equity investor or acquirer, the CRAs would have difficulty in maintaining Enron's rating at investment grade. Simultaneously, without an investment grade credit rating, Enron would surely face systematic default and bankruptcy, because it would constitute a triggering event under (private party) agreements. Counterparties in the options trade would also not trade with a below-investment grade trading company, and a "junk" credit rating would foreclose access to Enron's capital markets. The independent judgment of the CRAs, therefore, was significant and could have a decisive impact on Enron's downfall and how (and at what stage) it would affect the capital markets.

Enron was able to prolong its investment grade rating by the CRAs, though, because Dynegy Inc, another Houston energy company, expressed an interest in a merger with Enron. With the business combination, the new entity, according to Moody's, could maintain an investment grade rating, but

The SEC and private-sector watchdogs part two: More watchdogs—Wall street analysts and credit rating agencies" (October 8, 2002), p.110, available at <http://www.senate.gov> [Accessed February 24, 2009].

21. The first ground-breaking news came from Jonathan Weil in the *Wall Street Journal* of September 20, 2000. The reports followed in October 2001.

22. See Report prepared by the Staff of the Committee on Governmental Affairs, "Enron's credit rating: Enron's bankers' contact with Moody's and government officials" (January 3, 2003), 83-604, p.2.

23. "Junk" means all credit ratings below investment grade.

24. Enron's former President, Greg Whalley, reported that Enron's "business model [did not] exist below investment grade." Report prepared by the Staff of the Committee on Governmental Affairs, "Enron's credit rating", 2003, p.2.

17. See European Commission. *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*. COM (2008) 704 final, p.16, available at <http://www.ec.europa.eu>.

18. WorldCom was rated "investment grade" until 42 days before it filed for bankruptcy.

19. Kenneth Lay was the Chief Executive Officer (CEO) of Enron for years, with the exception of a few months in which he fulfilled the position of "Chairman".

20. See Report of the Staff to the Senate Committee on Governmental Affairs, "Financial oversight of Enron:

the first proposal was not acceptable to Moody's, because the merger agreement contained too many "outs" for Dynegy. Most significantly for Moody's, the agreement contained too many "material adverse changes" (MACs) clauses that allowed Dynegy to terminate the transaction, among others, upon a decline in Enron's credit rating.²⁵ Moody's was concerned about the transaction, because without the merger Enron could not sustain an investment grade rating, while the merger agreement contained MAC clauses, especially with regard to Enron's credit ratings. Moody's doubted whether Dynegy and the banks were sufficiently committed to the merger. As a result, Moody's decided to lower Enron's credit rating below investment grade on November 7, 2001. Moody's informed Enron of this decision on November 8, 2001, and would issue a press release that day announcing the downgrade.

Enron postponed its planned announcement of the merger, and made efforts to prevent the announcement of the downgrade by Moody's that day, and to encourage Moody's not to downgrade Enron's rating below investment grade. Soon after Moody's informed Enron of its planned downgrade, Moody's received phone calls from JP Morgan Chase, Citigroup, and ChevronTexaco, a major shareholder of Dynegy. Citigroup CEO Michael Carpenter expressed this concern to Moody's that any threat to the stability of Enron would seriously disrupt the energy markets. Moody's indicated that such a concern was rather an issue for the appropriate government agency to address, and that, when applicable, the Government could organise a "rescue" as it had done for Long Term Capital Management.²⁶ In a separate meeting on the same day, JP Morgan Chase expressed similar concerns to Moody's about the systemic risk of an Enron collapse—disruption in the energy and financial markets. Moody's responded to JP Morgan Chase that systemic risks issues were the Government's problem. When Citigroup and JP Morgan Chase approached the Treasury Department and the Federal Reserve Bank of New York, they indicated that it was a bad idea for them to interfere with the credit rating business. It was also no avail when Ken Lay contacted Commerce Secretary Don Evans for support vis-à-vis the CRAs.²⁷

All Moody's really wanted was the assurance that Dynegy was committed to the transaction. Only when Dynegy decided to remove the MAC clauses and raise the litigation thresholds, Moody's convened a credit committee to reconsider Enron's rating. Moody's determined that the new information constituted and

expressed a sufficient commitment to the merger by Dynegy, and therefore that a downgrade below investment grade was not warranted at the time (anymore). Therefore, on November 9, 2001, Moody's announced that it was lowering Enron's credit rating to "Baa3", the lowest investment grade rating and one notch above "junk". Fitch issued a two-notch downgrade on Enron to "BBB-" (just one level above "junk"), and Standard & Poor's also downgraded Enron to "BBB-" (one notch above "junk"). All three CRAs retained Enron's credit rating above investment grade through November 28, 2001, with the proposed merger with Dynegy as the principal justification. Despite another US \$500 million write-down on November 8, 2001, the possibility of financial fraud did not figure as a concern for the CRAs. Furthermore, on November 19, 2001, Enron filed its Form 10-Q, which disclosed that the Standard & Poor's downgrade on November 9, 2001 had triggered a demand obligation for US \$690 million, to the surprise of both the Enron management and the CRAs. This raised no important concerns for the CRAs and did not affect the credit rating of Enron. Only when over the next few days the likelihood of a merger seemed more and more remote, and on November 28, 2001, with reports that Dynegy had revised the agreement to include additional ways to terminate the transaction without additional cash infusions from the banks, did the CRAs decide to give up on Enron and downgrade Enron below investment grade. As a result, on November 28, 2001, Moody's downgraded Enron five notches to "B2", Standard & Poor's downgraded Enron six notches to "B-" and Fitch lowered Enron more than eight notches to "CC". Four days later, on December 1, 2001, Enron filed for bankruptcy.

The report of the US Congress on the basis of the Enron scandal contained serious criticisms of CRAs, especially because of the naive attitude of CRAs with regard to the financial information that Enron had provided them with. The report allotted the shortcomings of CRAs to their lack of accountability, i.e. their practical immunity from legal liability and non-existent regulatory oversight.²⁸ The report further concluded that the CRAs displayed insufficient review of company materials, while they were in a very good position to investigate possible misbehaviour. For example, the (famous) footnote 16 of Enron's annual report for the year 2000 ("10-K Report") referred to off-balance sheet entities that involved "contracting parties" actually in the service of Enron, but they were only assessed by the CRAs in relation to their possible impact on Enron's cash-flow. Standard & Poor's was aware of the off-balance sheet entities, because it had rated some of these in relation to their debt offerings, and with more diligent investigation could have become aware of the flaws in Enron's annual figures for the year 2000. Standard & Poor's could namely have concluded

25. Report prepared by the Staff of the Committee on Governmental Affairs, "Enron's credit rating", 2003, p.3.

26. Report prepared by the Staff of the Committee on Governmental Affairs, "Enron's credit rating", 2003, p.5.

27. Report prepared by the Staff of the Committee on Governmental Affairs, "Enron's credit rating", 2003, p.11, with a quote from Secretary O'Neil: "Can you believe Ken Lay called Don Evans and asked if he would intervene with the credit rating agencies?"

28. Report prepared by the Staff of the Committee on Governmental Affairs, "Enron's credit rating", 2003, p.116.

from Enron's final proxy statement for 2000 alone that there were transactions with "other parties" in which Enron itself was involved, and that there could (consequently) be downright fraud.

The disappointing achievements of CRAs during the current credit and financial crisis also make it necessary to express doubts about the role of CRAs on the financial markets.

What is the role of CRAs during the current credit crisis?

The current credit crisis has its origin in the loosening of the lending standards, in particular of mortgage loans, by financial institutions and service providers. In the United States, where the "bursting" of the bubble happened first, the process of relaxation of the lending standards was reinforced by corporations like Fanny Mae (Federal National Mortgage Association) and Freddy Mac (Federal Home Loan Mortgage Corporation), whose purpose is to promote private home ownership with government backing. With the help of CRAs mortgages obtained for example through the policy of Fanny Mae and Freddy Mac, could be wrapped up in securities and sold to institutional and big investors. These securities were traded globally so that the market for these securities (depending on the global risk preferences) had a larger degree of risk diversification. The results of the collapse of the structured finance market (not as a concept, but by size) would also be global, as the current credit crisis shows. The structured finance market, including the activities of CRAs, has been a non-transparent market to date still. In that respect the bankruptcy of one of the many banks that recently collapsed, e.g. Lehman Brothers, can provide a lot of information to find out in detail what exactly happened on the structured finance market.²⁹ The great challenge at the moment is to regulate the equally non-transparent credit default swap market, which also saw unprecedented growth because of the reinsurances of residential mortgage backed securities (RMBS) or securitisations.

It is an established fact that CRAs played a key role in the unprecedented growth of the structured finance market and, related to its collapse, in the current credit crisis and the ensuing financial crisis. The rise of the structured finance market, which reached a record in the years 2004–2006, ensured that financial institutions and service providers received the wrong impulses. The market for RMBS was not only used to shift risks according to the risk wishes of investors, but also as a means to generate substantial income. This applied not only to banks that received direct liquid means rather than an undifferentiated pool of mortgage loans, besides the fees for the sale of

securitisation securities and the management thereof. Also, the local mortgage advisor and/or trader was driven (naturally still) by the goal of selling as many mortgages as possible in order to bring in fees.

In this period the products also became more complex, for example by concentrating various RMBS into collateralized debt obligations (CDOs) and by making combinations with derivative products such as credit default swaps in order to imitate the achievements of RMBS.³⁰ Besides, more and more risky loans were wrapped into securities, including loans that were supported by limited documentation or even no documentation regarding the income of the debtor and loans with a security obtained by a second mortgage. In order to make the structured finance market profitable, the financial institutions would have to gain access to institutional and big private investors, such as mutual funds, pension funds, hedge funds, banks, special purpose vehicles (SPVs) and government funds. It was necessary for that purpose to obtain a credit rating from the big three CRAs, because the abovementioned investors would only (be able to) buy products having a very good credit rating. The legal entities that issued securities in the scope of a securitisation were structured in such a way that the largest tranches in the transaction always (just) received a triple-A credit rating.

The rising housing prices in the period 2002 to 2006 ensured that the loans underlying structured finance securities did well or even better than the CRAs had predicted. However, in mid-2007 the situation changed dramatically. Whilst the housing prices fell, defaults on the sub-prime mortgages rose. As a result, the CRAs revalued their ratings of sub-prime RMBS and CDOs. Finally they would make a downgrade of a large part of their original credit ratings. In February 2008, Moody's had decreased at least one tranche of 94.2 per cent of the RMBS, which it had assessed in 2006, including 100 per cent of the RMBS with collateral obtained from second mortgages, and 76.9 per cent of the offerings in 2007. As a whole, Moody's had lowered 53.7 per cent and 39.2 per cent of the sub-prime tranches in the respective years 2006 and 2007. As of March 2008, Standard & Poor's had lowered 44.3 per cent of the sub-prime tranches it had assessed between 2005 and the third quarter of 2007. This includes 87.2 per cent of the securities with collateral obtained from second mortgages. In December 2007, Fitch had lowered almost 34 per cent of the sub-prime tranches it had assessed in 2006 and the first quarter of 2007. In February 2008, Fitch had set all RMBS that it had assessed in 2006 and the first quarter of 2007 and that were supported by (first) sub-prime mortgages, at "Ratings Watch Negative".

The large-scale decrease of the credit ratings of sub-prime-related securities contributed to the concern of market players that the risks involved in the

29. cf. The Wharton School of the University of Pennsylvania, "AIG Rescued but Crisis Continues" (Podcast, September 22, 2008), available at <http://www.wharton.upenn.edu/> [Accessed February 24, 2009].

30. Due to lack of space I cannot elaborate here on the credit default swaps (CDS) market, which is estimated at US \$58 trillion.

possession of these securities were bigger than they had originally thought. This concern was particularly acute for investors who had fully relied on credit ratings to take an investment decision.³¹ Due to the lack of space I will not elaborate on the role of CRAs in the crisis in the banking sector as a result of the current credit crisis.³² In the past few months, various reports have been published about the role of CRAs during the credit crisis.³³ The reports of the SEC of June and July 2008, that of ESME of June 2008 with reference to the role of CRAs in the credit crisis, but also the recent Directive of the Commission³⁴ all conclude that the CRAs were insufficiently equipped in terms of quality and quantity of staff to fulfil their tasks in the structured finance market properly. The CRAs had no written procedures that related specifically to the assessment of RMBS and CDOs. The CRAs also did not do significant research into the underlying assets of loans of an RMBS (let alone of a CDO), and in some cases there was even no form of documentation at all about the loans underlying the RMBS. In the next section, I shall also discuss the reaction of legislators and regulators, particularly at the European level.

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What are the results of both crises for the credit rating industry?

The results of Enron and the current credit crisis are far-reaching for the credit rating industry. As a main result it can be mentioned that the (former)

NRSRO status has been abolished in the United States. Instead, CRAs that wish to be designated as an NRSRO can voluntarily register with the SEC. The SEC shall decide about this within a maximum of 120 days. Before, only seven CRAs were recognised as NRSRO (through the “no-action letter” process), but now (at the end of October 2008) 10 CRAs (including the seven old ones) have registered as NRSRO. Instead of Nationally Recognized Statistical Rating Organizations it is therefore better to call them Nationally Registered Statistical Rating Organizations.³⁵ The main criticism was that the NRSRO status had brought the big three CRAs into a privileged market position and still keeps them there. Only nationally recognised CRAs were eligible by the SEC for an NRSRO status, whilst only those CRAs that have an NRSRO status have a nationally recognised reputation, since a credit rating of an NRSRO-CRA is worth more in the view of enterprises and investors than a credit rating of a CRA that is not an NRSRO. By cancelling the so-called “nationally recognised” criterion (and its cyclic relationship to being an NRSRO), the US Congress attempted to break the existing power position of the big three CRAs.

Furthermore, various other aspects of the credit rating industry came to be criticised. The question is to what extent CRAs are subject to subtle forms of conflicts interests (and in this connection, the performance of ancillary services), to what extent CRAs treated relevant non-public information honourably, and to what extent CRAs abused their market position. These questions were even more adamant since there was no oversight, account or transparency in the credit rating industry whatsoever. Ancillary services included in particular the practice of enterprises presenting hypothetical situations to CRAs, such as the sale of important assets or a merger, asking them to predict what the impact would be for the credit rating of the enterprise. Such ancillary services make it not so easy for the CRA to come back to its prediction later, and because of the income from the ancillary services the CRA may compromise itself in an unpermitted way in its independent rating of the creditworthiness of the enterprise. Naturally, the enterprises themselves might also think that it could be helpful for the increase of their credit rating if they would first present a projected action to the CRA.

Ancillary services also included risk management and consulting services, which create similar problems as the consulting services of accountants (that are now prohibited). If CRAs oblige enterprises to purchase additional services or actually force enterprise to do so (out of fear for a lowering of the credit rating, also known as “tying”), this may constitute abuse of a market position. It may happen in structured finance transactions that a CRA refuses to assess a securities transaction if part of the securities has already been assessed by another CRA, or that the

31. See C. Cox, “Testimony concerning oversight of nationally recognized statistical rating organizations before the US senate committee on banking, housing and urban affairs” (US Securities and Exchange Commission (SEC) April 22, 2008), pp.4–5, available at <http://www.sec.gov> [Accessed February 24, 2009].

32. See for this: D. Coskun, “The Role of Credit Rating Agencies in Prudential Supervision. The Standardized Approach in Basel II Revisited” (forthcoming 2009).

33. See inter alia: ESME, “ESME’s report to the European Commission, Role of Credit Rating Agencies”, (June 2008), available at <http://ec.europa.eu/> [Accessed February 24, 2009]; IOSCO, Technical Committee of IOSCO, “The Role of Credit Rating Agencies in the Structured Finance Markets”, 2008, available at <http://www.iosco.org>; Financial Stability Forum (FSF), “Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience” (April 7, 2008), available at <http://www.fsforum.org> [Accessed February 24, 2009]; The Committee of European Securities Regulators (CESR), “CESR’s Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and The role of credit rating agencies in structured finance” (May 2008), available at <http://www.cesr-eu.org> [Accessed February 24, 2009]; SEC, “Annual Report to Congress under Section 6 of the Credit Rating Agency Reform Act of 2006” (June 2008), available at <http://www.sec.gov>; SEC, “Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies” (July 2008), available at <http://www.sec.gov>.

34. See European Commission. *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*. COM (2008) 704 final, available at <http://www.ec.europa.eu>.

35. Thanks to Frank Partnoy during the Amsterdam Center for Corporate Finance lunch of July 4, 2008.

CRA downgrades the securities transaction for that reason (“notching”). There is also a risk of employees of CRAs being able to abuse relevant, non-public information (which they received directly from the enterprises under an obligation of confidentiality) or to pass this information on to others (“tipping”). Besides, there may be classical conflicts of interest, for example when a credit rating analyst of the CRA holds securities of the enterprises they assess.

Finally, it is of course important that in order for supervision of CRAs to be effective, the supervisors must have access to the books and records of the CRAs in order to check whether one or more of the abovementioned practices occur. The American Congress and the SEC have already taken measures with regard to all the points mentioned above in the form of supervisory legislation and rules. These rules oblige CRAs that wish to be registered as NRSRO to publish some, and to store a large number, of data; they prohibit abuse of relevant non-public information; they prohibit some conflicts of interest and curb other conflicts of interest; they prohibit other practices that constitute abuse of a market position; and they give the SEC far-reaching powers of investigation and search, including access to internal communications and external emails regarding all aspects of the credit rating business. Due to a lack of space, I shall not elaborate on the conflicts of interest and the forms of abuse of market position that are prohibited in the United States and/or have been curbed for NRSROs.³⁶

As a result of the credit crisis, rules of the SEC are being prepared that supervise particularly the gathering of information and the achievements of CRAs.³⁷ NRSRO-CRAs are obliged to publish the (kind of) information on which a credit rating for a structured finance product is based, and to publish whether they have performed due diligence. NRSRO-CRAs must also publish (whilst stating the assessment criteria) how their credit ratings have performed, i.e. to what extent they were accurate with hindsight. The rules with regard to conflicts of interest concerning the credit rating process of a structured finance product will also be tightened. The involvement of CRAs in structured finance products has produced its conflicts of interest in a class of their own. For example, CRAs have both co-operated in the development of a structured finance product and in the eventual evaluation of that product, and of course they were rewarded in both cases. The close involvement of CRAs also meant that issuers were aware of the (informal) criteria of CRAs for the assessment of structured finance products. In that connection, issuers could organise their products in

36. For an exhaustive elaboration (until July 2008), I refer to D. Coskun, “Credit rating agencies in a post-Enron world. Congress revisits the NRSRO Concept” [2008] J.I.B.L.R. 9 4, 264–283, available at <http://www.palgrave-journals.com> [Accessed February 24, 2009].

37. See inter alia: SEC, “Annual Report to Congress under Section 6 of the Credit Rating Agency Reform Act of 2006” (June 2008), p.24 ff., available at <http://www.sec.gov>.

consultation with the CRAs and also independently in such a way that a minimal desired credit rating was obtained. Naturally, the bounds of what could only just produce a sufficient credit rating—an investment grade—was always looked for.

In the European Union, apart from the annual monitoring by the Committee of European Securities Regulators (CESR) of compliance with the Code of Conduct Fundamentals for CRAs of the International Organisation of Securities Commissions (IOSCO), there is no supervision yet on the ins and outs of CRAs. As mentioned above, CRAs are out of reach of Directive 2003/125 as regards the fair presentation of investment recommendations. However, the European Commission is of the view that CRAs are obliged to disclose conflicts of interest as a result of art.1(8) in conjunction with point 10 of Directive 2003/125.³⁸ Besides, the Market Abuse Directive• (MAD) applies to CRAs as far as there is market manipulation within the meaning of art.1 of the MAD, which is in the event that CRAs know or should know that their ratings are inaccurate. The European Commission and CESR are further of the view that the Member States are free to apply art.6(3) of the MAD to CRAs, so that CRAs can be obliged to draft insider lists with regard to insider information within the meaning of the MAD.³⁹ Finally, as far as CRAs expressly do provide investment recommendations on a professional basis, CRAs may be within the scope of the MiFID.

Furthermore, the European Commission has set to work energetically in connection with the current credit crisis.⁴⁰ The European Commission proposes drastic measures to supervise CRAs in the form of a CRAs Directive in 2009 (the “Directive”).⁴¹ The European Commission wishes to co-ordinate the supervision of CRAs as much as possible by establishing a central registration point at CESR that functions as a “one-stop-shop” for all supervisors in

38. See European Commission, “Communication from the Commission on Credit Rating Agencies”, (March 11, 2006, 2006/C59/02), available at <http://eur-lex.europa.eu>.

39. See European Commission, “Communication from the Commission on Credit Rating Agencies”, 2006, 2006/C59/02, available at <http://eur-lex.europa.eu>; CESR, Public Consultation, “Market Abuse Directive Level 3—Third set of CESR guidance and information on the common operation of the Directive to the market, CESR/08-274” (May 2008), available at <http://www.cesr-eu.org> [Accessed February 24, 2009]. See also Standard & Poor’s, “Response to Consultation: Level 3 - Third Set of CESR guidance and information on the common operation of the Market Abuse Directive (CESR/08-274)” (September 30, 2008), available at <http://www.standardandpoors.com> [Accessed February 24, 2009].

40. As opposed to the CESR’s firm opinion that establishing a private international supervisory committee under the umbrella of IOSCO is preferable above supervisory legislation.

41. See European Commission, “Consultation on a draft Directive / Regulation with respect to the authorisation, operation and supervision of credit rating agencies (CRAs)”, available at <http://www.ec.europa.eu> and European Commission, *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*. COM (2008) 704 final, available at <http://www.ec.europa.eu>.

CRAs matters. The responsibility for the registration and supervision of CRAs will be on the national supervisors, who will execute their supervision on site. A valid registration will apply throughout the European Union. It is important to mention here that it is explicitly not intended that supervisors interfere with regard to the substance of credit ratings (art.21(1) of the Directive).⁴²

The first observation to be made is that the Commission has expressly not chosen an official recognition, but a registration process for CRAs that wish to undertake activities within the European Union, in particular by publishing credit ratings that are used by financial institutions, including pension funds (art.4 of the Directive). CRAs that have their headquarters outside the European Union and issue credit ratings that are used by financial institutions are obliged to open an office in the European Union, so that this office can register through CESR and is subjected to supervision. A disadvantage of an official recognition process is that it gives CRAs an official appeal and that investors may interpret this as an official recognition or approval of the credit ratings of the CRAs. The result may be, for example, that (institutional) investors make their investment decisions too dependent on the opinion of CRAs. Enterprises that are aware of the importance of credit ratings to investors could react to that by tuning their behaviour to the expectations and assessment criteria of the CRAs, in order to get a good credit rating above all else. These possible perverse consequences may be mitigated because supervision legislation does not grant its imprimatur to CRAs through an official recognition. Furthermore, the experiences in the United States have taught us that an official recognition may lead to disruption of competition vis-à-vis new CRAs (with new views and methodologies), which may in turn lead to a decline in quality and integrity in the credit rating industry. Official CRAs automatically acquire a head start to CRAs not yet officially recognised. This may lead to a disruption of competition and may discourage new entrants. So the Commission too chooses a voluntary registration system rather than an official recognition, which is beneficial to international co-ordination, for example with the American SEC.

The proposal of the Commission concerns drastic measures for the credit rating industry, for example with regard to conflicts of interest and forms of abuse of market position. Some measures go even beyond those proposed by the SEC. In this connection, the Commission proposes that a CRA may not grant consulting services, for example with regard to the design of a structured finance instrument, and should exclusively limit itself to issuing credit ratings. The Commission also proposes that credit rating analysts may not work for more than four

consecutive years on the assessment of the same entities (art.6(4) of the Directive); and that they may not be rewarded according to the extent of income their credit ratings generate (art.6(6) of the Directive). CRAs must also have a sufficient number of people employed with appropriate knowledge and experience, for example to serve the structured finance market. The Commission also proposes that the body or part of the board of a CRA that supervises the board must at least have three independent non-executive directors, in accordance with item 13 s.3 of Recommendation 2005/162.⁴³ Another important example is that the Commission proposes to curb (or have curbed by national supervisors) the so-called practice of “rating shopping”, in which issuers call round at the various CRAs for a desired rating. The idea of the Commission is to achieve increased transparency and integrity by, respectively: (1) keeping data and making them public; and (2) adopting procedures to prevent abuse of relevant non-public information, unpermitted conflicts of interest, forms of abuse of market position, and practices deviating from established methodologies within the CRA. The supervisors are equipped with far-reaching investigative powers for this purpose, in particular access (on site) to all data, documents and communications. As the big stick, supervisors can repeal the official registration of a CRA; demand that certain practices that go against the Directive are ceased; halt the activities of a CRA temporarily with effect in the whole European Union; issue public warnings if the obligations in the Directive are not complied with; take appropriate measures to further compliance with those obligations; and present cases for criminal prosecution (arts 20 and 21 of the Directive).

Conclusion

In this article I have described the role of CRAs in corporate and finance decisions, especially with reference to the Enron scandal and the current credit and financial crisis. CRAs fulfil the role of gatekeepers to the financial markets, because an investment grade rating is often decisive for enterprises to get access to institutional and big investors and an investment grade rating gives a signal to other investors about the quality of the securities of an enterprise. During the Enron scandal, CRAs failed in their role as private gatekeepers. For example, CRAs played a role in the creation and performance of the activities of the entities outside the balance sheet of Enron. CRAs were in a good position to cast doubts on the fraudulent activities of Enron. However, CRAs think that they must be able to rely fully on the accountants with regard to the accuracy of the financial data of

42. See European Commission. *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*. COM (2008) 704 final, available at <http://www.ec.europa.eu>.

43. Recommendation 2005/162 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [2005] OJ L52/51.

the enterprises to be assessed. CRAs are using the same argument during the current credit crisis, in which the financial data underlying the securities in structured finance transactions have not been tested and/or consulted by CRAs.

The European Commission proposes a supervisory registration system, comparable to the system in the United States, which promotes the international coordination between supervisors. Experience in the United States has taught us that an official recognition has more disadvantages than advantages for the credit rating industry and the financial markets. An official recognition has a restrictive effect on new entrants to the credit rating industry, possibly with new opinions and methodologies for the assessment of credit risks. Besides, it may make market parties too dependent on CRAs and their credit ratings, because an official recognition may be interpreted as an imprimatur from supervisors. A voluntary registration system is therefore preferable to an official recognition process.

CRAs should behave responsibly towards enterprises and investors in various ways and with regard to various aspects of the credit rating business. This requires supervision legislation, both to protect CRAs

themselves in their independent formation of a judgment and in order to protect enterprises and investors from too high a dependence on CRAs and their credit ratings. What is important is that CRAs have not yet been punished by the market through private law liability for being wrong in their credit ratings, be it for corporate ratings or for structured ratings. While most jurisdictions also have no public-law basis for accountability and supervision. • Supervision is necessary in order to prevent unpermitted conflicts of interest, abuse of relevant non-public information, and forms of abuse of market position in the credit rating industry. At a European level, the Commission has presently proposed drastic measures, which will admittedly need adjustment, because in practice they may appear to be too drastic, for example, by discouraging de novo entrants. CRAs still attach great value to the issuer-pay model that has given CRAs relatively great rewards. In comparison, public oversight and market discipline have lagged behind somewhat, but the latter may gain further momentum in the coming months.

AQ6



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