REGULATING CREDIT RATING AGENCIES
AFTER THE FINANCIAL CRISIS: THE LONG AND
WINDING ROAD TOWARD ACCOUNTABILITY

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ABSTRACT

The credit crisis that started in the American mortgage subprime market in 2007 is having profound social and economic consequences. In this context, lawmakers, regulators, and commentators have questioned the role of rating agencies in the market turmoil. In light of the critiques, a strong consensus emerged that regulatory intervention was needed. The consensus was encapsulated in the Group of Twenty (G20) communiqué of April 2009 that stated that “We have agreed on more effective oversight of the activities of Credit Rating Agencies, as they are essential market participants”. Thus, a number of reform initiatives are under way in Canada, Europe and the United States to address the concerns raised by credit rating agencies’ activities in the context of structured finance products.

The paper provides a critical assessment of the regulatory initiatives put forward on both sides of the Atlantic to address the problems which have affected the accuracy of the ratings as well as the integrity of the ratings process. The first part of the paper offers some background relating to the subprime credit crisis. The second part moves to an analysis of the role of CRAs in the context of the structured finance products. Finally, after having highlighted the failings of CRAs’ in the asset-backed securities market, the paper presents the reform initiatives. It offers a critical comparative examination of the strategies for enhancing the accountability and effectiveness of CRAs.
The credit crisis that started in the American mortgage subprime market in 2007 is having profound social and economic consequences. The impact of the crisis extends well beyond the American markets as the subprime loans were packaged in structured finance products, such as residential mortgage-backed securities and collateralized debt obligations, widely held by institutional and retail investors across the world. In Canada, the crisis was felt through the collapse of the asset-backed commercial paper market that happened when investors realized that they were exposed to an unknown quantity of subprime mortgage linked securities.

As the corporate scandals that shattered investor confidence at the beginning of the 2000s, the credit market turmoil is the product of a perfect storm resulting from failures on the part of issuers, intermediaries, investors, regulators and governments. Still, observers note that credit rating agencies (CRAs) played a significant role in the market turmoil because of the characteristics of structured finance products which made

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investors particularly dependent on ratings.\textsuperscript{5} Thus, questions have been raised with respect to the quality and integrity of the rating process. To address these concerns, a number of reform initiatives are under way in North America and Europe. The initiatives, which vary in their scope and approaches, seek to enhance the accountability and effectiveness of rating agencies.

The purpose of this paper is to discuss the regulatory initiatives put forward in order to inform the policy response contemplated by the Canadian Securities Administrators.\textsuperscript{6} The first part of the paper offers some background relating to the subprime credit crisis. The second part moves to an analysis of the role of CRAs in the context of the structured finance products. Finally, after having highlighted the failings of CRAs’ in the asset-backed securities market, the paper presents the reform initiatives put forward in North America and Europe. It then offers a critical comparative analysis of the strategies for enhancing the accountability and effectiveness of CRAs.

I. BACKGROUND RELATING TO THE CREDIT CRISIS

A. An Introduction to Securitization

1. Securitization Involving Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDO)

Securitization is considered to be one of the most important financing techniques developed in the last decades.\textsuperscript{7} In the United States, asset-backed securities amounted to a value of $2,480 billion in the first quarter of 2008 according to the Securities Industry Financial Markets Association. In contrast, the value of Canadian asset-backed securities was of $157.8 billion as of April 30\textsuperscript{th} 2008 following Dominion Bonds Rating Services.


The technique of securitization can be summarized as follows.\(^8\) A corporation (the “originator”) seeks to raise funds using revenue generating assets that it owns. After having identified such assets, the originator transfers them to special purpose vehicle (“SPV”) through a sale. Transferring the assets is meant to shield those assets from risks related to the originator. To pay for the assets, the SPV issues debt-like securities in the capital markets. The cash flows generated by the assets are used to make monthly and principal payments to investors holding the securities. From this perspective, investors are concerned more about the revenue generated by the assets, than the originator’s overall financial condition. As a result of securitization, the receivables transferred to the SPV are transformed into capital market instruments.

In the context of the subprime crisis, securitization involved two types of securities: residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs).\(^9\) With RMBS, the SPV issues securities whose payments derive from residential mortgage loans that it owns. With CDOs, the securities are backed by a mixed pool of mortgage loans and other income-generating assets.\(^10\) Over the past few years, the volume and complexity of RMBS and CDOs have witnessed a substantial growth. At the same time, they became increasingly linked to subprime retail mortgages for reasons discussed below.\(^11\)

The SPV issues different classes or “tranches” of RMBS or CDO securities ranked by their level of credit protection: “Credit protection is designed to shield the tranche securities from the loss of interest and principal due to defaults of the loans in the

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8 For a summary, see M. ZANDI, Financial Shock: a 360 look at the subprime mortgage implosion, and how to avoid the next financial crisis, FT Press, Upper Saddle River, 2008.


10 SECURITIES AND EXCHANGE COMMISSION, Summary Report of Issues Identified in the Commission’s Staff Examinations of Select Credit Rating Agencies, July 2008, p. 7 (noting that a CDO is comprised of 200 or so debt securities).

pool”. The tranche offering the highest level of protection, *i.e.* the highest seniority of payment, is called senior securities. Lower priority classes are designated subordinated or junior securities, in the case of RMBS, and mezzanine securities in the case of CDOs.

A particularity with securitization involving RMBS and CDOs concerns the process for creating the securities. Unlike with classic securitization, the originator is different from the corporation that creates the SPV to buy the assets. Typically, an investment bank (the “arranger”) would buy the loans and receivables from companies, package them into a pool and transfer them to an SPV that would then issue securities collateralized by those assets.

A central element of the creation and distribution of RMBS and CDOs is obtaining a credit rating for each of the tranches of securities issued by the SPV. The ratings provide an evaluation of the creditworthiness of the securities and determine whether their distribution is viable. Indeed, as notes Schwarcz, “[i]nvestors rely on the assigned ratings to determine the minimum return that they will accept on any given investments”.

In the U.S., the Securities and Exchange Commission regulates public offerings of RMBS and CDOs namely by imposing disclosure requirements. However, asset-backed securities are usually offered privately to qualified institutional buyers rather than publicly. Nonetheless, in institutional private placements, the extent of disclosure is the product of negotiations between investors, originators and issuers, which lead to the preparation of extensive offering memoranda.
2. Asset-Backed Commercial Paper (ABCP)

Commercial paper is a type of short-term debt, *e.g.* promissory notes, that has been used by corporations to finance their short-term need for cash.\(^{15}\) Purchasers of commercial paper are corporations with excess liquidity which buy the notes as an alternative to short-term deposits. Commercial paper has traditionally been considered to be a low-risk security as it was issued by crown corporations, municipalities and established publicly-listed corporations. Following Canadian securities regulation, distribution of commercial paper is exempted from the registration and prospectus requirements in reliance with various exemptions provided by National Instrument 45-106.\(^{16}\)

Asset-backed commercial paper (ABCP) was introduced in Canada at the end of the 1980s.\(^{17}\) This form of commercial paper consists of short-term notes backed by a package of assets such as credit card and trade receivables, auto and equipment leases, mortgages, and other cash-flow generating assets.\(^{18}\) Since the beginning of the new millennium, asset-backed commercial paper has gained in popularity with investors. Thus, the ABCP market continued to experience spectacular growth, doubling between 2000 and 2007 to $120 billion.

A typical ABCP transaction structure involves the creation of an ABCP conduit, which is a special purpose vehicle that issues short-term notes to investors and uses the


\(^{16}\) For instance, it can be issued in reliance on the short-term debt exemption of section 2.35 of *National Instrument 45-106 – Prospectus and Registration Exemptions* of where it does not mature later than one year from issuance, it is not convertible or otherwise exchangeable for another security, and has an “approved credit rating” from an “approved rating organization”.


proceeds to purchase assets. The conduits are created by sponsors which can be business corporations, banks and third-party that specialize in structured finance using securitization. Sponsors are “responsible for arranging deals with asset providers, determining the term of the program and acting as the agent for the programs with respect to securitization”.

Conduits can buy “traditional assets” (or bank-originated assets) or synthetic assets, that is assets backed by derivative contracts. Over the last years, given that most of Canadian consumer debt had been securitized into ABCP, conduits increasingly purchased longer-term synthetic assets such as RMBS and CDOs to satisfy investor demand for commercial paper. This trend was reinforced by the presence of third-party sponsors who did not have access to bank-originated assets.

The conduits purchase the financial assets with funds raised by selling securities collateralized by the pool of assets. The securities issued by the conduits, or notes, usually have maturities of 30 to 60 days. With the cash flow generated by the assets, the ABCP conduit pays the interests on the notes and redeems them at maturity. Rating agencies rate the commercial paper, that is they provide an assessment of the probability of default of the conduit on its obligations in light of its underlying assets.

The structure also provides for liquidity facilities for the ABCP conduits which purport to ensure that they can pay the maturing notes in cases of liquidity stress. The liquidity facilities are also important where conduits fund long-term assets with short-term debt. As the IIROC report remarks, “[w]ithout liquidity protection, the conduit would be unable to sell its paper to investors because they would be unwilling to bear the default risk”.

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In Canada, two types of liquidity facilities existed. With the first type (the “global style” agreement), banks acted as liquidity provider to the conduits regardless of market disruption. With the second (the “Canadian style” agreement), liquidity was provided by financial institutions, frequently foreign banks, in case of “general market disruption”, a concept put forth in Guideline B-5 of the Office of the Superintendent of Financial Institutions (OSFI). The Canadian style agreement entailed a much more limited protection against liquidity risk. Indeed, it appears that market participants defined general market disruption “as a situation in which not a single dollar of corporate or asset-backed commercial paper can be placed in the market – at any price”. It is therefore not surprising that a general market disruption was considered to be a highly unlikely event. In any event, S&P and Moody’s were not at ease with this second type of liquidity facilities as they considered its scope to be too narrow. Hence, they refrained from rating Canadian ABCP, leaving DBRS as the single rating agency.

B. The Subprime Crisis and Its Impact on Asset-backed Commercial Paper

The starting point of the credit crisis takes its roots in the U.S. Government policy to expand home ownership amongst low-income earners. The “Homebuilder-Realtor-
Mortgage Broker Industrial Complex” sought to enhance the availability of affordable housing using creative financing techniques. The influence of those lobbies was magnified by the economic conditions of the last decade which helped keeping interest rates relatively low during that period. Mortgage financing increased as did house prices. More importantly, the level of subprime mortgage loans rose significantly with the loosening of credit standards. In parallel, given the low interest rates, investors searching for higher yields were more inclined to invest in more complex structured products, such as RMBS and CDOs. Innovations in structured products theoretically reduced the risk associated with asset-backed securities, rendering them thereby more attractive to institutional investors.

Starting in late 2005, a significant rise in the delinquency and foreclosure rates on subprime mortgage loans altered this picture to launch a chain of events that contributed to the credit crisis. According to Crouhy & Turnbull, four reasons explain the significant rise in delinquencies and foreclosures. Firstly, subprime borrowers had the possibility to finance the entire value of their homes through mortgage products, i.e. without having to make a down payment. Secondly, lenders increasingly proposed subprime mortgage of the “short reset” type whereby the borrower is initially charged an interest rate that is much lower than the standard rate for two to three years, which is increased afterwards to a much higher rate. Thirdly, the rising home values led a number of subprime borrowers to anticipate refinancing or repaying their mortgages early through the sale of their home. Finally, investor demand for asset-backed securities led mortgage originators to loosen credit standards to supply subprime assets.

At the end of 2006, the rising rate of defaults coupled with the lowering of property values heightened the level of investor uncertainty, as subprime mortages


plummeted below estimates: “investors feared that widespread foreclosures could further depress property prices, creating even more uncertainty about potential CDO losses.”31 In the summer of 2007, the uncertainty spurred a liquidity crisis among institutional investors and hedge funds. Their confidence shattered, investors began withdrawing their investments in RMBS and CDOs. At the same time, demand for asset-backed securities collapsed, making it difficult for institutions to sell those assets to repay lenders and investors. Further complicating the situation was the downgrade of RMBS and CDOs by rating agencies which contributed to reduce the attractiveness of these securities. In this context, institutional investors and hedge funds had to sell their investments in liquid publicly traded securities in order to face lenders and investors demand, thereby creating a ripple effect in markets thought to be unrelated to asset-backed securities. Ultimately, the crisis forced U.S.-based banks and investment banks to take huge losses subprime-related securities, structured investment vehicles, leveraged loans and commercial mortgage lending32. Most notable, this led to the downfall of Bear, Stearns.

From a Canadian perspective, the subprime crisis had a profound impact on the ABCP market. When the crisis unfolded in the summer of 2007, investors holding ABCP began to realize that the assets underlying the commercial paper included RMBS and CDOs. Investor confidence was seriously challenged, even more so given the uncertainty surrounding the degree of exposure of commercial paper to the subprime mortgage market.

The crisis was fuelled largely by a lack of transparency in the ABCP scheme. investors could not tell what assets were backing their notes – partly because the ABCP Notes were often sold before or at the same time as the assets backing them were acquired; partly because of the sheer complexity of certain of the underlying assets; and partly because of assertions of confidentiality by those involved with the assets. As fears arising from the spreading U.S. sub-prime mortgage crisis mushroomed, investors became increasingly concerned that their ABCP Notes may be supported by those crumbling assets.33


Thus, demand for new issues of commercial paper dried out as investors were turning to safer investments. The conduits having issued commercial paper were caught in a liquidity crisis as notes were coming due and margin calls were triggered. Although the liquidity facilities could have provided a solution, banks refused to extend emergency loans to the conduits subject to the Canadian style agreement arguing that there had not be a general disruption of the market. To avoid a greater crisis, key stakeholders agreed to a standstill of the $32 billion Canadian market in third-party ABCP. The standstill, known as the Montreal Protocol, led to a restructuring of the ABCP market which sought to “preserve the value of the notes and assets, satisfy the various stakeholders to the extent possible, and restore confidence in an important segment of the Canadian financial marketplace”. The restructuring was put forward by the Pan-Canadian Investors Committee chaired by Purdy Crawford as a plan of arrangement and compromise under the Companies’ Creditors Arrangement Act. The arrangement was sanctioned on in June 2008 by the Superior Court, and confirmed by the Court of Appeal later in August 2008.

II. RATING AGENCIES AND STRUCTURED FINANCE PRODUCTS

A. The Role and Regulation of Rating Agencies

1. Credit Rating Agencies and the Operations of Capital Markets

CRAs are pervasive institutions. The Basel Committee on Banking Supervision estimated that there were over 130 agencies worldwide, with about 30 of them playing a prominent role in G10 countries. Rating agencies may operate at a national, regional, or even global scale. Some provide ratings, solicited or unsolicited, on a limited number of

34 Metcalfe & Mansfield Alternative Investments II Corp., (Re), 2008 ONCA 587, par. 23.
issuers while others have the capability of rating all issuers in a given marketplace using statistical models. Ratings can focus on specific fixed-income securities, including complex financial instruments issued in structured finance, as well as on issuers, such as corporations, municipalities, and governments. Aside from providing ratings, CRAs also offer ancillary services. These services include rating assessment services, whereby they provide an evaluation of the impact of contemplated corporate action on an issuer’s rating. Other services include risk management and consulting services designed to assist financial institutions and other corporations in their management of credit and operational risk.

Three of the largest CRAs operating on a global scale are based in the United States. They are Moody’s, Standard & Poor’s (“S&P”), and Fitch. These three U.S. rating agencies, which also operate in Canada, are well known and their activities have been amply chronicled. In Canada, there are two major Canadian CRAs, Dominion Bond Rating Services (“DBRS”) and Canadian Bond Rating Services (“CBRS”), which has recently been purchased by Standard & Poor’s.

Traditionally, CRAs earned their revenues from subscriber fees paid by investors. In the early 1970s, CRAs changed their business model and started charging issuers for their rating services. Nowadays, the larger CRAs derive most of their revenues from the fees charged to issuers.

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Credit rating agencies provide an evaluation of the creditworthiness of issuers, which is essentially an assessment of how likely they are to make timely payments on their debts in general. They also offer ratings of individual debt instruments that indicate the probability of default or delayed payment with respect to that particular security. The ratings do not express opinions on whether the particular debt securities should be bought or sold. They are only intended to convey information regarding the relative safety of the securities. Since their primary function is to evaluate credit risk, CRAs do not assess the economic appeal of investments. Individual investors may prefer to purchase less creditworthy instruments as they receive appropriate compensation for the added risk acceptable. Furthermore, a credit rating does not express the agency’s opinion of the actual value of an issuer’s equity securities. To summarize, the activities of CRAs can contribute to the efficiency of capital markets by rectifying some of the information asymmetries that exist between issuers and investors.

With respect to structured finance products, ratings are arguably valuable for both issuers and investors. Ratings assist investors in their assessment of the risk and uncertainties associated with asset-backed securities, thereby helping them make investment decisions. From this perspective, “rating agencies perform the same function as securities law: reducing the information asymmetry between issuers of securities and investors”. In the case of asset-backed securities, the contribution of

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ratings in this respect is buttressed by their access to private information on the securities, in particular their underlying assets.

Stated differently, CRAs act as certifying agents by offering their reputation to supplement that of the issuer as a guarantee of quality.\(^\text{48}\) For prospective investors to be convinced of the accuracy of certification, the signal conveyed by CRAs must be credible itself. This requires that three conditions be met.\(^\text{49}\) Firstly, the certifying agent must have reputational capital at stake, which would be adversely and materially affected by incorrectly certifying as accurately priced an issue that was actually overvalued. Secondly, the value of the agent’s reputational capital must be greater than the gains to be made from false certification. Thirdly, it must be costly for issuers to purchase the services of the certifying agents, “and this cost must be an increasing function of the scope and potential importance of the information asymmetry”.\(^\text{50}\) CRAs probably meet these three criteria.\(^\text{51}\) Rating agencies have reputational capital at stake when they issue ratings and would likely suffer a greater loss from falsely certifying the quality of an issue than they would gain in fees. Finally, the production of ratings is costly.

2. Current Regulation

a) Canada

In Canada, many federal and provincial regulatory schemes refer to ratings issued by CRAs.\(^\text{52}\) In a nutshell, the regulatory regimes rely on such ratings to distinguish


\(^{52}\) On the regulatory use of ratings, see C. Nicholls, Public and Private Uses of Ratings, Toronto, Capital Markets Institute, 2005.
investment-grade from speculative securities. For instance, the distinction between investment-grade and speculative securities serves in prudential regulation in the banking and investment dealing industries.\(^53\) It is also used to identify securities in which certain types of institutional investors can invest without prior authorization. In securities regulation, issuers of investment-grade securities benefit from particular exemptions designed to reduce the regulatory burden to reflect the lower level of risk of their securities.\(^54\) Despite the rather broad use of ratings, there is no principled approach with respect to CRAs.\(^55\) In fact, the organization and activities of CRAs are not regulated per se. Whereas regulatory regimes only recognize ratings issued by “approved” or “recognized” rating agencies, these expressions are only defined through a rudimentary listing of large CRAs.\(^56\)

b) United States

In the United States, regulatory schemes use ratings for similar purpose as in Canada.\(^57\) Since 1975, regulations have traditionally required that ratings be issued from a “nationally recognized statistical rating organization” (NRSRO) designated by the SEC.\(^58\) Thus, rating agencies that do not have NRSRO status are barred from a significant segment of the market.\(^59\) Despite its importance, the term NRSRO had not been officially

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\(^{53}\) Money Market Mutual Fund Conditions Regulations SORS/2001-475, S. 2. a) (ii), 2. c), 2. d) (ii), (iii); INVESTMENT DEALERS ASSOCIATION, Rule Book, s. 100.4E f), g); Cross Border Leases Relating to Toronto Transit, O. Reg. 157/03, s. 3. (1), 4. (5), 6.

\(^{54}\) See, e.g., National Instrument 44-101, Short Form Prospectus Distributions.


\(^{56}\) Regulatory regimes typically refer to Canadian Bond Rating Services, Dominion Bond Rating Services, Moody’s, Standard & Poor’s, Fitch, Duff & Phelps, and Thomson BankWatch.


defined, nor had criteria for NRSRO designation formally adopted. Through the no-action letter process, the SEC staff had developed a number of criteria that it considers relevant to NRSRO designation. Amongst those criteria, the most important was that the applicant had to be “nationally recognized by the predominant users of ratings in the United States as an issuer of credible and reliable ratings”. According to experts, the weight attributed to this factor created a Catch-22 problem: “an agency has to be nationally recognized to be an NRSRO but has to be an NRSRO to become nationally recognized.” In sum, the framework clearly favoured existing rating agencies that were already recognized as NRSROs.

In the wake of the corporate scandals that were unearthed in the early 2000s, rating agencies have been criticized for failing to play their role of watchdog. Following a number of studies conducted by academics, lawmakers and regulators, reform was introduced by the U.S. Congress and subsequently by the Securities and Exchange Commission (SEC). The Congress adopted the Credit Rating Agency Reform Act of 2006 which purport to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit


rating industry.” The provisions of the Act, and the grants of rulemaking power to the SEC that they provide, form the basis of a registration and regulatory program for CRAs that seek to obtain the NRSRO status.

The 2006 Act purport to create an objective registration framework through which rating organizations may apply for NRSRO status. It seeks thereby to facilitate entry by agencies that could not previously qualify under the former NRSRO designation process. Relying on its rulemaking authority, in 2007, the Commission enacted rules that govern the registration of CRAs. The rules impose disclosure and record-keeping obligations. They also prohibit several types of conflicts of interests. However, pursuant to the Act, the SEC does not have the power to “regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings”.

c) European Union
CRAs have traditionally been unregulated entities in the European Union, although their activities and relevance were recognized by three Directives. Following the implosion of Enron, The Committee of European Securities Regulators (CESR) conducted a study for the European Union Commission that recommended that legislation was not necessary to address the failings of CRAs. The Commission relied on the IOSCO Code of Conduct implemented through self-regulation to ensure the accountability of CRAs. In parallel, CESR was charged with the responsibility of monitoring compliance with the

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67 The long title of the act is An Act To improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.


69 Credit Rating Agency Reform Act of 2006, P.L. 109-291, s. 15E.


71 COMMITTEE OF EUROPEAN SECURITIES REGULATORS, CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005.
IOSCO Code and report to the Commission annually in this respect. After a first CESR report noting that CRAs generally complied with the Code, the Commission concluded that while improvements were desirable, the case in favour of specific legislation remained unproven.  

**B. The Process for Rating Structured Finance Products**

All of the most important CRAs organize the rating process around similar procedures and mechanisms, adapting it to the particularities of the securities and issuers being rated. From a structural perspective, CRAs establish a rating committee to initiate withdraw or review a rating. A rating committee is generally formed *ad hoc* and is composed of a lead analyst, managing directors, and junior analytical staff.

Specifically, the process followed by rating agencies to establish the ratings of RMBS and CDOs begins with the arranger of the contacting an agency and providing them with data on the underlying assets, *i.e.* the subprime loans, the proposed capital structure of the SPV and the proposed levels of credit enhancement for each tranche of securities issued. In this respect, note that whereas the rating of corporate debt securities relies of publicly available information, the rating of asset-backed securities is essentially based on private information not accessible to investors. Following the initial contact with the rating agency, an analyst undertakes a number of analyses in order to determine the rating that would be given to the tranches.

First, a loss analysis is conducted with respect to each tranche in light of characteristics of the loans in the collateral pool: “The purpose of this loss analysis is to

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**72** COMMUNICATION FROM THE COMMISSION ON CREDIT RATING AGENCIES, Official Journal of the European Union, 2006/C 59/02, 59/5


**74** The process followed by rating agencies to establish the ratings of RMBS and CDOs have been recently summarized in a report by the Staff of the Securities and Exchange Commission. SECURITIES AND EXCHANGE COMMISSION, Summary Report of Issues Identified in the Commission’s Staff Examinations of Select Credit Rating Agencies, July 2008, p. 20-22.
determine how much credit enhancement a given tranche security would need for a particular category of credit rating.” 75 Secondly, the proposed capital structure of the SPV is examined to assess what level of rating it meets. Thirdly, agencies make a cash flow analysis which seeks to gauge the principal and interests to be paid out by the SPV and estimate whether the underlying assets are sufficient to meet the amount due on each tranche. Finally, the analyst develops a rating proposal for each tranche, which is then submitted to a rating committee. The committee votes on the analyst’s recommendation and transmits the decision to the arranger.

Interestingly, the arranger has the discretion to decide whether or not to have the credit rating issued and made public. Where the rating is disclosed to the public, the rating agency gets paid. Otherwise, it only receives a breakup fee. Subsequently to the disclosure of the rating, the rating agency monitors the issuer and its securities by reviewing corporate filings, monitoring industry trends, and maintaining contact with corporate management. When necessary, the CRA will put the issuer on a “watch list” to indicate that it is considering reviewing the rating issued.

C. Concerns over the Role of Rating Agencies in the Structured Finance Market

1. Transparency

Given the contribution that make CRAs in resolving information asymmetries, it is crucial that their ratings and rating processes be transparent. In this respect, the events related to the credit crisis have led commentators to criticize the level of transparency concerning the rating of asset-backed securities. 76 The critiques point to inadequate disclosure by CRAs of their methodologies, in particular key assumptions and ratings criteria. 77 Commentators also emphasize that CRAs were not sufficiently forthcoming


with respect to the limitations of their ratings. In particular, questions are raised as to whether CRAs provided adequate disclosure of the absence of due diligence verification of the data they were provided with to issue the ratings. Finally, CRAs did not always provide to investors verifiable and easily comparable historical performance data regarding their ratings.\(^{78}\)

Transparency issues extend beyond CRAs. Asset-backed securities are typically issued under a prospectus exemption. In this unregulated environment, voluntary disclosure proves unsatisfactory.\(^{79}\) The complex legal structures that surround this type of securities remained opaque. Thus, important information on credit and liquidity enhancements was not available. Further, investors did not have access to fundamental information on the underlying assets to make their own assessments of credit risk.

2. The Quality of the Rating Process

Studies conducted into the role of CRAs in the context of the credit crisis raised a number of critiques with respect to the quality of the rating process.\(^{80}\) Three critiques are noteworthy.

The first critique relates to the resources committed to the rating of asset-backed securities.\(^{81}\) From 2002 to 2006, the market for RMBS and CDOs experienced substantial growth. At the same time, the products were becoming increasingly complex. Rating agencies struggled with the growth in volume and complexity. They experienced difficulties with their rating process as staff increases did not always match this growth. For instance, ratings could be issued despite issues being unresolved. Likewise, resource-constraints hampered agencies’ ability to monitor in a timely fashion the rating assigned. Thus, CRAs were found to be slow in reviewing and, when required, downgrade existing

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ratings.\textsuperscript{82} Note that critiques of the timeliness of rating changes are not new. Rating agencies have been severely criticized for their performance in the continual monitoring of ratings assigned in the past.\textsuperscript{83} For example, CRAs maintained Enron’s credit rating at above investment grade as late as November 28, 2001, only a few days before it filed for bankruptcy.\textsuperscript{84} Agencies were also criticized for keeping the ratings for General Motors and Ford just above investment grade at a time where the market traded the bonds of those corporations “at spreads equivalent to junk status”.\textsuperscript{85}

A second critique concerns the agencies’ practices with respect to the information provided to them. CRAs “did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated”.\textsuperscript{86} Further, they did not require that issuers perform due diligence to ensure the integrity or reliability of the information provided, even though poor information quality affected their assessments.\textsuperscript{87} While this approach raises criticism, it is important to stress that it was publicly disclosed by the agencies. Moreover, CRAs had no legal duty existed to perform due diligence.

Finally, some question the effectiveness of the methodologies used by agencies to rate asset-backed securities.\textsuperscript{88} Specifically, the critiques stress that CRAs do not have a

\begin{footnotesize}
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\item \textsuperscript{83} For an overview of the salient cases where CRAs did not “get it right”, see T.J. SINCLAIR, \textit{The New Masters of Capital}, Ithaca, Cornell University Press, 2005, p. 156-172.
\item \textsuperscript{85} “Who rates the raters?”, \textit{The Economist}, March 26, 2005, p. 91.
\item \textsuperscript{87} F. NORRIS, “Moody’s Official Concedes Failure in some Ratings”, \textit{The New York Times}, January 26, 2008, reporting that Moody’s Chief executive officer lamented that the completeness and veracity of the information provided deteriorated as the subprime mortgage grew; R. LOWENSTEIN, “Triple-A Failure”, \textit{The New York Times Magazine}, April 27, 2008
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long track record in rating such securities, in contrast with conventional debt securities. Crouhy and Turnbull argue that this may have led agencies to rely on models which did not cover all of the risk dimensions of asset-backed securities, such as market liquidity risk. Thus, the European Securities Market Experts Group noted that the inordinate level of downgrading of structured products following the initial rating “appears to indicate that the methodologies were inadequate and suggests that the CRAs staff did not have an adequate understanding of the structured finance market, or at least in the subprime residential mortgage market”. Without going as far, the Staff of the SEC remarked that the agencies examined did not have specific written procedures for rating RMBS and CDOs, or for addressing errors in their models or methodologies. Further, it noted that agencies did not document the rationale for rating decisions deviating from the models used. Again this critique is not entirely new as many have previously questioned the reliability of ratings, expressing doubts as to whether agencies conduct sufficiently thorough analyses of the various issuers whose debt they rate.

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90 EUROPEAN SECURITIES MARKETS EXPERT GROUP, Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 11.


3. Conflicts of Interest

Credit rating agencies act as intermediaries between the issuers they rate and investors. Intermediation leads CRAs to act on behalf of both issuers and investors. From an economic perspective, the relationship that exists between a rating agency and issuers or investors can thus be qualified as being one of agency. The interaction between agents and their principals gives rise to potential agency problems.

With respect to CRAs, a first agency problem relates to the investors-CRAs axis. Under the current business model, CRAs are paid by issuers to provide ratings. Thus, the dominant CRAs receive most of their revenue from the issuers that they rate. The practice of issuers paying for their own ratings creates a potential conflict of interests for CRAs that is well known. Under such circumstances, agencies may be tempted to downplay the credit risk of issuers and to inflate their ratings in order to retain their business. The practice of charging fees based on the size of offerings also renders CRAs more vulnerable to pressure by larger issuers.

In the context of the subprime crisis, a number of factors influence the intensity of the conflict of interest associated with the issuer-pays model. First, the arranger has the ability to adjust the deal structure to obtain the rating sought. Where it is also acting as underwriter, the arranger has the ability to influence the choice of rating agency. Second, there is a high level of concentration in the underwriting business for RMBS and CDOs.

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which compounds the influence of the firms acting as arrangers and underwriters.  

Third, rating structured finance products generates high profit margins for rating agencies, which increase the incentive of CRAs in securing future business from arrangers. In this respect, recall that under the traditional model rating agencies only get paid where the issuer elects to “buy” the rating. Finally, unsolicited ratings are rarely possible in structured finance because of the relevant information is mostly privately held. This deprives the market from an independent check on the ratings issued.

According to the Staff of the SEC, this “combination of the arranger’s influence in determining the choice of rating agencies and the high concentration of arrangers with this influence appear to have heightened the inherent conflicts of interest that exist in the issuer pays compensation model”. More precisely, it noted that analysts “appeared to be aware, when rating an issuer, of the rating agency’s business interest in securing the rating of the deal”. Further, agencies did not take measures to curtail the influence of this dimension into the ratings or ratings criteria. Concretely, the conflicts of interest may have translated in rating agencies clinging to older rating criteria in order to satisfy the arrangers’ preference for a fast and predictable ratings process which allows them to complete a greater volume of deals.

The second problem relates to the issuers-CRAs axis. The development of consulting services by CRAs creates another source of potential conflicts of interests. The rating decisions may be influenced by whether or not an issuer purchases additional services offered by a CRA. Moreover, issuers may feel the need to subscribe to such services simply “out of fear that their failure to do so could adversely impact their credit

rating (or, conversely, with the expectation that purchasing these services could help their credit rating).”103 In the case of structured finance transactions, this risk proved to be quite present as it was customary for CRAs to advise issuers as to how to design the SPV in order to obtain the rating contemplated.104

III. RATING AGENCIES AND THE CREDIT CRISIS

A. Current Reform Initiatives

A number of observers have questioned the role of rating agencies in the recent credit market turmoil. In light of the critiques highlighted above, a strong consensus emerged that regulatory intervention was needed. This consensus was encapsulated in the Group of Twenty (G20) communiqué of April 2009: “We have agreed on more effective oversight of the activities of Credit Rating Agencies, as they are essential market participants”.105 Thus, a number of reform initiatives are under way to address the concerns raised by CRAs’ activities in the context of structured finance products.

Specifically, at the international level, the IOSCO has amended its Code of Conduct Fundamentals to buttress its provisions dealing with the quality and integrity of the rating process, conflicts of interest, and CRAs’ responsibilities toward investors and issuers.106 At the regional level, the European Parliament has adopted a Proposal by the European Commission for a Regulation on Credit Rating Agencies which includes a legally binding registration and surveillance regime.107 At the national level, in the United States, the SEC has adopted final rules amendment dealing with NRSROs “with


the goal of further enhancing the utility of NRSRO disclosure to investors, strengthening
the integrity of the ratings process, and more effectively addressing the potential conflicts
of interest inherent in the rating process for structured finance products”.\(^{108}\) Finally, in
Canada, the Canadian Securities Administrators (CSA) has released Consultation Paper
11-405 that proposes the enactment of a regulatory framework applicable to “approved
credit rating organizations” which is based on a “comply or explain” approach in light of
the IOSCO Code of Conduct.\(^{109}\)

This section presents an overview of the substance of the proposed initiatives in
order to appreciate the breadth of the ongoing reforms.

1. The Rating Process

The EU Regulation and the IOSCO Code of Conduct amendments seek to enhance the
accuracy of the ratings of asset-backed securities. They purport to ensure that rating
agencies devote additional efforts to assess the reliability of the information concerning
the assets underlying the securities that they rate as well as gain a better understanding of
them. The proposals deal with the methodologies and processes followed to rate
securities, as well as with the monitoring and updating of the ratings.\(^{110}\)

\(^{108}\) U.S., SECURITIES AND EXCHANGE COMMISSION, Proposed Rules for Nationally Recognized
25, 6456. See also U.S., SECURITIES AND EXCHANGE COMMISSION, Proposed Rules for Nationally
Recognized Statistical Rating Organizations, Release No. 34–57967; File No. S7–13–08, Federal Register,
vol. 73, no. 123, 36218. In parallel to those reform initiatives, New York state attorney general Andrew
Cuomo reached an agreement with the three principal U.S. rating agencies, Moody’s, S&P, and Fitch, that
imposes significant changes on the latter’s organization and operations. See “Attorney General Cuomo
Announces Landmark Reform Agreements With The Nation’s Three Principal Credit Rating Agencies”,
June 5, 2008 [online: http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html]. A. LUCHETTI,
“Big Credit-Rating Firms Agree to Reforms”, Wall Street Journal, June 6, 2008, at C3. In addition,
Congressman Tom Rooney introduced the Rating Accountability and Enhancement Act of 2009, H.R. 3214
or RATE Act on July 14 [on line: http://www.govtrack.us/congress/bill.xpd?bill=h111-3214].

\(^{109}\) CANADIAN SECURITIES ADMINISTRATORS, Securities Regulatory Proposals Stemming from the
2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada, Consultation Paper 11-405,
2008.

\(^{110}\) Commission Staff Working Document accompanying the Proposal for a Regulation of the
European Parliament and of the Council on Credit Rating Agencies, COM (2008) 704, November 12,
2008, p. 8; INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, The Role of Rating Agencies in
At a general level, the IOSCO Code of conduct and the EU Regulation provide that CRAs should review periodically their methodologies and models. To enhance the reliability of the ratings, these instruments state that CRAs should also adopt reasonable measures so that the information it uses is of sufficient quality to support a credible rating. In addition, CRAs must ensure that their employees making up the rating committees have appropriate knowledge and experience.

The IOSCO Code and the EU Regulation require that CRAs monitor and update their ratings. Further, the Code stipulates that agencies should take steps to ensure that the decision-making process for reviewing and potentially downgrading a current rating of a structured finance product is conducted in an objective manner. For instance, agencies could choose to vest the monitoring of structured finance products to a different team from the one that issued the initial rating.

2. Independence and Conflicts of Interest

The conflicts of interest of agencies attract the most attention, given their potential impact on the rating process. It is therefore not surprising that the reforms proposed by the EU, the IOSCO, and the SEC all seek to curb conflicts of interest and their consequences.\(^\text{111}\) The IOSCO and the SEC reforms are more targeted than those of the E.U. which aim at implementing a new regulatory framework for CRAs.

Following the SEC amendments, Rule 17g-5 prohibits an NRSRO to issue or maintain a rating with respect to an obligor or security where it has made recommendation to the obligor, or the issuer, underwriter or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. In other words, “the rule prohibits an NRSRO from rating its own work or

\(^{111}\) The Cuomo Settlement introduces a reform of the traditional compensation model following which agencies get paid only if they are retained to rate the securities. Pursuant to the agreement, CRAs will now operate with a fee-for-service structure whereby they will get compensated for their analysis, irrespective of whether they are selected to rate the product. This shift in the compensation model should make agencies less vulnerable to issuer pressure. See “Attorney General Cuomo Announces Landmark Reform Agreements With The Nation’s Three Principal Credit Rating Agencies’, June 5, 2008 [online: http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html].
the work of an affiliate”.\textsuperscript{112} Rule 17g-5 also introduces a prohibition that already exists in the IOSCO Code and which bars anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it. Finally, the rule prohibits conflicts of interest related to receipt of gifts. Thus, an NRSRO cannot issue or maintain a rating whenever persons responsible for determining or approving credit ratings receive gifts from the persons being rated or the sponsors of the latter.

With respect to the IOSCO Code of Conduct which already dealt with conflicts of interest and independence extensively, the new provisions add a prohibition that bar analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.\textsuperscript{113} The Code also requires the establishment of policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer that the analyst has rated, or a financial firm with which an analyst has had significant dealings as an employee of the CRA. The IOSCO Code also imposes additional requirements with respect to the compensation of agencies’ analyst. Specifically, agencies should conduct formal and periodic reviews of remuneration policies and practices for CRA analysts to ensure that these policies and practices do not compromise the objectivity of the CRA’s rating process.

Finally, the EU Regulation enacts provisions to “ensure that the issuance of a credit rating is not affected by any existing or potential conflict of interest or business relationship involving the credit rating agency issuing the credit rating, its managers, employees or any person directly or indirectly linked to it by control”.\textsuperscript{114} To do so, it sets forth a detailed list of requirements that are similar to those of the IOSCO Code of Conduct. Most notably, like the IOSCO Code and the SEC Rules, the Regulation prohibits a rating agency from providing consultancy or advisory services to an entity it is


rating. Though ancillary services are permitted, CRAs’ analysts shall not make proposals or recommendations with respect to the design of structured finance products on which the agency is expected to issue a rating.

3. Transparency

Transparency is considered to be an effective tool to address failures in financial markets. Thus, the reform proposals seek to enhance the transparency of the ratings and rating process. In this respect, it is the SEC that relies the most on this regulatory tool.

At a general level, the EU Regulation follows the IOSCO and SEC requirements by mandating the disclosure of CRAs’ methodologies, models and key rating assumptions it uses in the rating process.

More specifically, the SEC is buttressing mandatory disclosure with respect to the rating process in order to assist investors in assessing the quality of the ratings. The SEC requires that NRSROs communicate all of their ratings and subsequent rating actions, as well as performance statistics for one, three and ten years within each rating category. Likewise, the EU Regulation mandates the periodic disclosure of data on the historical default rates of rating categories. Interestingly, it requires CESR to create a publicly available central depository for standardised data on CRA performance.

With respect to methodologies and process, pursuant to SEC amendments agencies must disclose whether and, if so, how information about verification performed on the assets underlying a structured product is relied on in determining credit ratings. In addition, agencies are compelled to disclose whether, and if so, how assessment of the quality of originators of assets play a part in the determination of credit ratings. Further, the rules require that NRSROs indicate how frequently they


review ratings and whether different models are used for ratings surveillance than for initial ratings. In this respect, they would prepare an annual report of the number of ratings actions they took in each ratings class.

Reforms initiated by the European Commission and the IOSCO would impose similar requirements. Thus, the EU Regulation compels the disclosure of all substantially material sources used to prepare the rating, the principal methodology relied upon, the meaning of each rating category, and the date at which the rating was first released. Further, CRAs must disclose whether it considers satisfactory the quality of information available on the rated entity and to what extent it has verified the information it was provided with. When announcing a credit rating, the CRA shall explain in its press release or report the key elements underlying the credit rating.

The IOSCO Code already enjoined CRAs to strive for transparency with respect to their ratings and rating processes. Following the amendments, it mandates greater disclosure on the rating process, including information on the methodology used, and the analysis and verification conducted, in order to give investors a better understanding of the meaning of the ratings.

Finally, the IOSCO and EU reforms call upon CRAs to differentiate the ratings for structured products from other securities. Thus, the IOSCO Code now states that CRAs should differentiate ratings of structured finance products from other ratings, preferably through different rating symbols. The EU Regulation states that ratings for structured finance products must have different rating categories that may be used to rate other types of rated entities or financial instruments. Alternatively, the agency must publish a report that provides a detailed description of the rating methodology used to determine the rating and an explanation of how it differs from the determination of

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ratings for any other type of rated entity or financial instrument, and how the credit risk characteristics associated with a structured finance instrument differ from the risks related to any other type of rated entity or financial instrument. Although it proposed a new rule that would require NRSROs to distinguish ratings for structured instruments from other classes of ratings, the SEC has not so far finalized this reform.

4. Enhancing Competition in the Rating Industry
   a) Disclosure of Information on Asset-backed Securities

A first reform initiative to enhance competition in the rating industry with respect to structured finance products seeks to address the barrier stemming from the relative absence of public information on asset-backed securities. The IOSCO states that “CRAs as an industry should encourage structured finance issuers and originators of structured finance products to publicly disclose all relevant information” concerning structured products.\(^\text{121}\) Likewise, the CSA contemplate requiring public disclosure of all information provided by an issuer that is used by a CRA in rating an asset-backed security.\(^\text{122}\) Such disclosure would enable other rating agencies to issue “unsolicited ratings”. Although they are sometimes criticized, unsolicited ratings can counterbalance the rating shopping bias that arises when agencies sell favourable ratings to gain or maintain market shares. In addition, with the disclosure of relevant information with respect to these securities, investors would have the ability to conduct more easily their own analyses.

In its proposed amendments, the SEC contemplated imposing a similar requirement by prohibiting an NRSRO from issuing or maintaining a credit rating for a structured finance product paid by the product’s issuer, sponsor or underwriter unless the information on the characteristics of assets underlying the product is available. In light of the significant legal issues raised by the proposal, the SEC re-proposed the amendment to


limit the disclosure obligation to the NRSRO not retained to issue a credit rating.\textsuperscript{123} Stated differently, the NRSRO issuing the rating would not have to disclose the information with respect to the underlying assets to the public in general.

b) Regulatory Use of Ratings

The regulatory use of ratings combined with the particularities of the asset-backed securities markets raise questions as to the influence ratings may have had in the credit crisis. Professor Frank Partnoy doubts that rating agencies make a meaningful contribution in reducing information asymmetries.\textsuperscript{124} Rather, issuers and investors rely on ratings because of their regulatory use.

Recently, the IOSCO stressed that investors had tended to give too much weight to the ratings, viewing them as “a seal of approval”.\textsuperscript{125} Thus, investors tended not to conduct their own analysis of the characteristics of asset-backed securities, relying heavily or solely on the ratings to assess the risk of holding these securities. Investors’ reliance on ratings was certainly not unreasonable given the regulatory treatment of ratings, the role of CRAs in advising originators, and the challenges raised by risk analysis.\textsuperscript{126} Still, the IOSCO Report notes that this may have led some investors to rely inappropriately “on CRA credit ratings as their sole method of assessing the risk of holding these securities.”\textsuperscript{127} Likewise, the SEC recognized the existence of “a risk that investors interpret the use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to

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  \item \textsuperscript{126} R. Lowenstein, “Triple-A Failure”, \textit{The New York Times Magazine}, April 27, 2008. However, it is debatable whether institutional investors can solely rely on ratings to assess the creditworthiness of issuers, in light of their duty of care.
\end{itemize}
place undue reliance on the credit ratings issued by these entities.\textsuperscript{128} Ultimately, over-reliance on ratings magnified the market turmoil once investors started questioning their quality in light of the massive downgrading that was occurring and were left without any alternating to make their risk assessment.

Although the “regulatory license” critique of CRAs remains debated, the SEC seems to have taken side with those who question the influence the regulatory use of ratings in the credit crisis. The SEC issued three proposals on July 1, 2008 which aim to reduce undue reliance on credit ratings by investors and improving the analysis underlying investment decisions.\textsuperscript{129} Essentially, the proposals would do away with rating requirements in a number of instruments related to asset-backed securities and money market funds. For instance, the SEC proposes to amend Form S-3 which governs offering of asset-backed securities via shelf registration to eliminate the provision that allows the sale of investment grade securities to the public, and replace it with new conditions.\textsuperscript{130} Similarly, the rule governing the operation of money market funds would no longer have a minimum rating requirement as an eligibility criterion for investment. The eligibility of securities would be determined by the fund’s board of directors, assessing whether the investment presents minimal credit risk. So far, the SEC has not however finalized those reform proposals.

In Canada, the ABCP turmoil underscores similar problems. Recall that ABCP was distributed through the prospectus exemption for short-term debt which essentially requires that the commercial paper have an “approved credit rating” from “an approved credit rating organization”. According to investigation by the financial press, ABCP was routinely being sold to investors based on their rating, irrespective of the underlying


\textsuperscript{130} The investment grade condition would be replaced with two new requirements: (1) that the initial and subsequent sale be in minimum denominations of $250 000; and (2) that the sales be made to qualified institutional buyers.
The combination of the investment grade rating with the lack of additional regulatory requirements enabled retail investors to have access to ABCP. Further, in the case of derivative-backed commercial paper, only DBRS rated the securities, depriving thereby investors from alternative perspectives. Any investor seeking to analyse these securities faced the challenge of accessing the relevant information which was rarely publicly available.

Canadian regulators are currently contemplating regulatory action along the lines of the US initiatives. The CSA Consultation Paper states that the “Committee is analyzing whether the approach taken by the SEC could inform its proposals to maintain, modify or delete references to credit ratings in Canadian securities legislation”. Specifically, the Committee is considering whether to reduce the reliance on credit ratings in the case of short-form and shelf prospectus eligibility, guaranteed debt exemption, and alternative credit support.

B. A Critical Assessment of the Current Reform Initiatives

In reaction to the failures of CRAs, lawmakers and regulators have replied vigorously with a wave of reform initiatives. The initiatives put forward seek to enhance the accountability and effectiveness of rating agencies by dealing with a wide range of issues. The initiatives vary in their regulatory approach. On one end of the spectrum, the IOSCO Code of Conduct is a pure market-based strategy relying on competition and reputation as disciplinary mechanisms. On the other end of the spectrum, the European Regulation sets forth a registration model with detailed rules of conduct with respect to independence and conflicts of interest, quality of ratings, and disclosure and transparency. The SEC and CSA reforms fall between these two poles, relying on both market- and regulatory-based strategies.

This section offers a critical comparative examination of the strategies for enhancing the accountability and effectiveness of CRAs. While the analysis highlights

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the limited effectiveness of market-based strategies (or market failures), the discussion also reveals the shortcomings of regulatory approaches. Indeed, when discussing policy options, it is important to remember that government failures can also exist.

Two types of government failures can exist. The first arises where the government is guided by the public interest. Even under such circumstances, regulation generates costs that must be taken into account when assessing the utility of government intervention. A second type of government failure surfaces where the assumption concerning the competence of government officials and the objective guiding their interventions is relaxed.

These two types of failures have undesirable implications when making policy choices. The first is the need to consider that regulation generates costs that may offset any efficiency gains sought. Even where there is a market failure, government intervention may not always yield a superior outcome. Any case for regulatory intervention will thus have to demonstrate not only that a market imperfection exists, but that its impact would be reduced by the proposed policy measure or reform in a cost-effective manner. Thus, the analysis of policy options concerning CRAs must take cost-effectiveness into consideration. The second implication involves considering that the goal of efficiency may be compromised when private interests groups capture the regulator. Where such capture occurs, the risk that regulation be biased against entry and competition surfaces. In light of this risk, Mayer cautions that “[t]he scope of regulation should therefore be limited to areas where there is a clear case of market failure”. From this perspective, enhancing the accountability of CRAs requires balancing the failings of both market and regulatory mechanisms. This involves evaluating the regulatory options in light


of market-based incentives that exist to address the various problematic issues affecting CRAs. Thus, “[w]here the market has an incentive to correct for any failings, less interventionist regulation is required”.

1. The Limited Effectiveness of Market-based Strategies
   a) Competition

   The credit rating industry is highly concentrated. At the international level, the IOSCO reports that Moody’s, S&P and Fitch dominate the credit rating business, with over 94% of the global market. These three agencies are also the dominant players in the U.S. In Canada, the rating industry is also concentrated with one Canadian organization, DBRS, acting alongside American CRAs.

   The barriers to entry that contribute to market concentration are well-known and have been discussed extensively elsewhere. A first set of barriers stems from the market itself. Reputation acts as a powerful barrier to entry as it can only be built over time: “New entrants to the credit rating business face the particular challenge of having to develop and demonstrate a track record to acquire credibility with investors which is

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138 Ibid.


necessary to persuade issuers to buy their rating service. Economies of scale and scope in the rating industry also give an advantage to incumbents.

Regulation also acts as a barrier to entry. In the U.S., prior to the adoption of the Credit Rating Agency Reform Act of 2006, commentators noted that the NRSRO designation process acted as a significant regulatory hurdle for new entrants, which was compounded by the regulatory-use of ratings. Likewise, in Canada, regulations may impose barriers to entry by referring to the ratings issued by large CRAs that have the status of “recognized rating organization”. To develop their business, new agencies need to be recognized by securities commissions. As it was the case in the U.S. until recently, recognition is made problematic by the lack of precision of the criteria and processes on which commissions base their decision.

Market concentration is worrisome. Insufficient competition deprives the public from an effective check on the quality and integrity of the rating process, thereby facilitating shirking by established CRAs. Lack of competition also negatively affects

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143 EUROPEAN SECURITIES MARKETS EXPERT GROUP, Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 11.


innovation, as well as diversity of thinking and opinions." In the context of the current credit crisis, the European Securities Markets Expert Group aptly notes that this “opens up the significant possibility that the underlying flaws and issues in the subprime market would have been identified in a more coherent and timely manner and accordingly communicated to the market” if there had been more competition. Interestingly, it is precisely the diversity of rating agencies opinions in Canada with respect to ABCP that provided investors with a warning on the quality of the commercial paper which had the Canadian-style liquidity provision, as the U.S. rating agencies declined to rate such asset-backed securities. Unfortunately, investors did not pay attention to those warnings.

A related concern is that competition is important for the enforcement of reputational sanctions that shape CRAs’ conduct. In a competitive market, information about prices charged, the level of service provided, and performance, tends to be more visible. Furthermore, there are more alternatives with which to compare services offered. Thus, in an oligopolistic setting, the reputational mechanism is less effective.

From this perspective, one avenue for reform is to improve competition in the credit rating industry. In light of the discussion above, one option is to remove the regulatory-induced barriers to competition. The U.S. has moved into that direction with the adoption the 2006 Act that purport enhance competition by clarifying the NRSRO designation process. In Canada, the CSA Consultation Paper proposes that the “approved credit rating organization” definition dovetails with the NRSRO designation, adhering thereby implicitly to the American reform. While it leaves open the recognition of additional credit rating organization by securities commissions, the Consultation Paper unfortunately provides no guidance with respect to the criteria that would guide the recognition decision. The formulation of clear criteria for other rating agencies to obtain

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149 EUROPEAN SECURITIES MARKETS EXPERT GROUP, Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 11.


the status of “approved credit rating organization” in Canada appears certainly desirable for the CSA approach to be coherent with the goal of enhancing competition. The European Union reform runs counter to the North American approach by erecting new regulatory barriers to entry, and ignoring the role of competition.\textsuperscript{152}

Removing regulatory barriers also requires revising the regulatory use of ratings. Indeed, reference to ratings in laws and regulations consolidate the dominant position of established rating agencies according to the regulatory-license view of ratings. This option has been discussed above.

Nonetheless, the importance of regulatory barriers to entry should not be overstated.\textsuperscript{153} Indeed, there were very few rating agencies in the U.S. even before the introduction of NRSRO regulation in 1975. In Canada, even if the regulatory framework is not as restrictive as in the U.S., there was never large number of rating organizations. Although there is merit to reforming the NRSRO designation process, the impact the reform may have a limited impact on the number of rating agencies.

To enhance competition, Grundfest and Petrova propose to create “sophisticated, well capitalized new market entrants with strong incentives to promote an investor’s point of view in the rating process”.\textsuperscript{154} These entrants, named Buyer Owned and Controlled Rating Agencies (BOCRAs), would be entities owned and operated by the largest institutional investors acting on debt markets. The SEC would make room for BOCRAs by creating a new category of rating agencies. It would support their operations by mandating that every NRSRO rating be supplemented by a BOCRA rating paid for by issuers.

This original proposal raises a number of issues. At a general level, it appears to be a complicated way of implementing a form of investor-pay model. At a specific level, do large institutional investors have the incentive to contribute to the creation of such


rating organizations? After all, institutional investors could have gone forward with such a solution already by establishing a not-for-profit organization that would independently rate issuers and securities, and disclose the ratings publicly. In light of Grundfest and Petrova’s model, even without an NRSRO status, the ratings issued by such an organization would have been useful for investors. Alternatively, rather than create BOCRAs, why would the institutional buyers not subscribe to the services offered by an investor-pay NRSRO, such as Egan Jones, to support the development of more independent securities ratings?

At any rate, many doubt that lifting regulatory barriers to entry to enhance competition constitutes an effective solution. Firstly, new entrants may be acquired by existing CRAs, as it has been the case previously. Secondly, even if new NRSROs remain independent, it will likely be “a difficult and slow process for a new entrant to become an established and credible player”.155

Finally, and more fundamentally, some argue that enhancing competition may prove to be counter-productive.156 Following Klein and Leffler’s model,157 competition could reduce the disciplinary effect of reputation. Greater competition would reduce the rent derived by rating agencies from their reputation, thereby affecting their incentive to preserve it. This argument is supported by recent empirical evidence marshaled by Becker and Milbourn studying rating agencies.158

Ultimately, increasing competition is an avenue that is worth pursuing, despite the limits underlined above. Whether credit ratings is a natural monopoly is an empirical question that can only be really tested if barriers to entry are lifted. For this reason, we

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155 EUROPEAN SECURITIES MARKETS EXPERT GROUP, Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 11.


consider that the European approach that eschews competition may have unfortunate unintended consequences for the accountability of rating agencies.

b) Reputation
Issuers are only willing to pay for the service of rating agencies if it reduces their cost of capital. Therefore, investors must consider that the agency’s opinion diminishes information asymmetries in that it accurately certifies issuers’ creditworthiness. The value of this certification depends on the CRA’s reputation with respect to accuracy, independence, and integrity. If a CRA has a reputation for erratic or biased analysis, investors will discount the value of the ratings assigned. If investors doubt the accuracy or independence of the ratings of a particular CRA, issuers will seek a more credible agency to signal their creditworthiness. Because of its value, CRAs’ reputation provides an economic incentive to behave diligently and ethically, even in the absence of regulation.

Many express doubts as to the effectiveness of reputational pressures for a number of reasons. Reputation is a noisy indicator. Investors are only privy to rating agencies’ efforts indirectly through the default rate of the debt-instruments that are rated. Thus, investors may attribute the same reputational effect to debt-instruments that fail for different reasons such as fraud, bad luck or inaccurate rating. The lack of transparency of the rating process further complicates the task for investors who want to assess the contribution of an agency.

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In addition, CRAs may be prone to herding, as other financial intermediaries.\textsuperscript{162} For instance, the European Securities Markets Experts Group notes that although CRAs expressed concerns regarding the evolving subprime market, they had, to a large extent, a consensus position and did not anticipate in their ratings the scale of the deterioration that ultimately transpired and led to the crisis of confidence in their ratings.\textsuperscript{163} Herding may be particularly true in periods of crisis: “rating agencies can intensify their mutual observations, thus producing similar ratings in order to avoid being the only one wrong.”\textsuperscript{164} Interestingly, herding is paradoxical. On the one hand, it may be used by rating agencies to protect their reputational capital. On the other hand, it hampers the disciplinary role of reputation by making it difficult for markets participants to differentiate amongst rating agencies, as they issue similar ratings.

For reputation to play a disciplinary role, it must exist. In this respect, Hunt argues that in the case of new investment products rating agencies have no reputation at stake, as they have never rated them.\textsuperscript{165} Thus, the effectiveness of reputational pressures is doubtful for novel products. Hunt’s position seems however difficult to reconcile with the events surrounding the credit crisis. Indeed, an argument can be made that it is precisely because of an over-reliance on the reputation of CRAs that investors did not appreciate the risk underlying structured finance products.

Finally, imperfect competition also reduces the effectiveness of reputational pressures. Even if an agency suffers a loss of reputation, new entrants may not be able to displace it because of the barriers to entry. Hence, a loss of reputation may not necessarily translate into a loss of market share for an agency, thereby mitigating the impact of reputational pressures on established agencies. Still, there exist mechanisms that can support reputational sanctions. Ratings are publicly disclosed and accessible to

\begin{footnotesize}
\begin{enumerate}
\item EUROPEAN SECURITIES MARKETS EXPERT GROUP, \textit{Role of Credit Rating Agencies}, Report to the European Commission, 2008, p. 11.
\item D. Kerwer, \textit{Standardising as Governance: The case of credit rating agencies}, Bonn, Max-Plank Institute, 2001, p. 25.
\item J.P. Hunt, “Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement”, [2009] \textit{Colum. Bus. L. Rev.} 109
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investors. In addition, other information intermediaries exist, such as financial analysts, in-house rating analysts, and niche players, which also provide investors with data on the creditworthiness of issuers.

To summarize, reputational pressures are currently insufficient to effectively discipline CRAs. Reputational pressures nonetheless do exist. Therefore, reform initiatives should take into account their influence and, to the extent possible, seek to enhance them.

c) Investors-Pay Model (or Restoring the Principal-Agent Relation)

Traditionally, CRAs earned their revenues from subscriber fees paid by investors.\(^\text{166}\) In the early 1970s, CRAs changed their business model and started charging issuers for their rating services.\(^\text{167}\) Nowadays, the larger CRAs derive most of their revenues from the fees charged to issuers.\(^\text{168}\) Given that this business model is the source of serious criticism, commentators have advocated doing away with it and proposed “to restore the principal-agent relationship that once existed by requiring rating agencies to be paid by the users of their information, not the issuer”.\(^\text{169}\) Although it appears seducing and simple, this option faces a number of important barriers that raise question as to its feasibility and effectiveness.

The most notable barrier is the public good aspect of ratings. Research on creditworthiness is similar to a public good in that it is difficult to limit its accessibility by excluding those investors who have not paid for it. In the case of credit ratings, exclusion is particularly difficult given that the information translates into symbols that


\(^{167}\) L.J. White, ibid.

\(^{168}\) See Basel Committee on Banking Supervision, Basel Committee on Banking Supervision, Credit Ratings and Complimentary Sources of Credit Quality Information, Working Papers No. 3, Basel, 2000, p. 25.

encapsulate the assessments of the rating organization. Ratings are therefore easy to leak and communicate to non-paying third parties. This public good problem would threaten the viability of the rating industry and certainly affect the quality of ratings.\textsuperscript{170}

Even if rating agencies were able to overcome this problem, the case for restoring an investor-pay model would still be fragile. To the extent that ratings would only be available to subscribers in such model, the general investing public would be deprived of information about creditworthiness, including about rating actions such as downgrades.\textsuperscript{171} This result would have at least two adverse consequences for market efficiency. Firstly, it would restrict the scope of ratings information dissemination. Secondly, it would limit public scrutiny of ratings as fewer investors would have access to them or would be able to compare them with ratings issued by another organization.\textsuperscript{172} Further, where CRAs would base their ratings on non-public information, subscribers would gain an informational advantage over the public. As Coffee notes, this could easily be viewed “as institutionalizing a de facto system of selective disclosure”,\textsuperscript{173} a result that would run counter to the objectives of the disclosure regime put in place by securities regulators.

A final concern with an investor-pay model pertains to its impact on coverage.\textsuperscript{174} There is a risk that this model induces a bias in favor of established entities or sectors as investors remain concerned about their current holdings. If it were to be the case, this result could stifle financial innovation and create barriers to entry for new issuers.


\textsuperscript{171} STANDARD & POOR’S, An Examination of How Investor Needs Are Served By Various Ratings Business Models: Ensuring Analytical Independence And Preventing Conflicts of Interest At Credit Rating Firms, Executive Comment, April 10, 2009, p. 5.

\textsuperscript{172} See also M. ZEMMER, “Reforming the Credit-Rating Process”, Financial System Review, December 2002, 51, 52.


\textsuperscript{174} STANDARD & POOR’S, An Examination of How Investor Needs Are Served By Various Ratings Business Models: Ensuring Analytical Independence And Preventing Conflicts of Interest At Credit Rating Firms, Executive Comment, April 10, 2009, p. 5.
d) Self-Regulation

Self-regulation is an option that has been previously advocated by CESR and the IOSCO.175 Following this option, CRAs self-regulate through the adoption of a voluntary code of conduct, using the IOSCO Code as a model.176 Pursuant to the comply or explain approach, rating agencies are expected to disclose their codes, and explain whether their provisions deviate from those of the IOSCO Code. Where it is the case, they should explain how the deviations nonetheless achieve the objectives of the Code.

From an efficiency perspective, self-regulation does not involve significant administrative costs and is a relatively simple way of attaining harmonization. This model avoids the difficult question of setting requirements for the recognition of organizations as credit rating agencies. CRAs would have the discretion of adopting the IOSCO Code “off-the-rack” or developing their own code of conduct. This prevents the creation of additional barriers to entry and would reduce the risk of lowering competition.

Compliance and enforcement issues pose important limit to the effectiveness of self-regulation.177 In this framework, reputation is the main incentive leading CRAs to adopt a code of conduct modelled on the IOSCO Code, and to respect its provisions.178 However, self-regulation does not provide any solution to the limits of reputational pressures. Furthermore, if the degree of disclosure is left to the discretion of CRAs, there is a possibility that “the market would not be properly informed on how – and in which measure – the CRAs are implementing the IOSCO Code”.179 In the absence of effective


178 COMMITTEE OF EUROPEAN SECURITIES REGULATORS, CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005, p. 42.

179 COMMITTEE OF EUROPEAN SECURITIES REGULATORS, CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005. p. 43.
compliance and enforcement mechanisms, it remains unclear whether CRAs could be held accountable to market participants.\textsuperscript{180}

Lastly, when thinking about the self-regulation option, consideration must be given to the current environment which is marked by a loss of confidence by market participants toward CRAs. Evidently, self-regulation cannot on its own restore public confidence.\textsuperscript{181} It amounts more or less to maintaining the status quo, a choice that is not likely to cure the perceived failings of CRAs. In light of the recent events, the European Commission staff was sanguine about self-regulation: “Self-regulation has been tested since 2006 and the outcome is far from acceptable”.\textsuperscript{182}

2. The Uncertain Promises of the Regulatory Path

a) Government Utility Model

The strongest form of regulatory intervention would be for the government to get involved in providing credit ratings.\textsuperscript{183} This solution rests on the classic welfare economics approach pursuant to which in presence of public goods the "government may be in a better position to operate a firm than the private sector."\textsuperscript{184} Involving the government in the provision of ratings could take a number of forms. For instance, the government could decide to create a public credit ratings organization to compete with the private CRAs. Alternatively,

\begin{itemize}
    \item \textsuperscript{180} COMMITTEE OF EUROPEAN SECURITIES REGULATORS, CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005, p. 43. COMMITTEE OF EUROPEAN SECURITIES REGULATORS, 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, p. 58-59.
\end{itemize}
existing rating agencies could be “nationalized” and transformed into government utilities. Admittedly, the political feasibility of these two choices is highly questionable. Nonetheless, it remains interesting to examine what would be the attractions and challenges of a government utility model.

With respect to attractions, relying on the government utility model to provide credit ratings could arguably solve the public good dilemma. The government would have the power to charge fees to issuers and investors, or to impose a tax on issuance of public debt to finance its ratings services. With this financing secured, the utility would have the ability to publicly disseminate the ratings to the benefit of the investing public in general. In parallel, this would give the rating organization the incentive to cover new issuers or investment products, thereby ensuring that the market is well-served. Another benefit from this funding formula is that it could alleviate the conflicts of interests that exist under the issuer-pays model.

Of course, we can only speculate as to whether a government-sponsored rating organization would issue more accurate ratings. Assuming that a government utility could offer at least an adequate level of quality in its ratings, the utility model would nonetheless face important challenges. Concentrating the ratings and financing decisions with the government would be problematic. The government would have to determine whether every debt-like security must be rated. Stated differently, the government would need to establish the optimal level of credit ratings information in the market. Likewise, it would have to set the optimal amount of fees or tax to fund the utility’s activities and provide it with the right incentives.

A second challenge concerns conflicts of interests. Doing away with the issuer-pays model would not eliminate all conflicts. The utility would face a conflict of interest whenever it would be called upon to rate government bonds. The utility could also be “captured” by interests groups, including the government, pressuring it to issue favourable ratings in their own interests – or privilege methodologies which serve those interests.

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A third concern is the impact of the government utility’s ratings on investors’ decision-making process. Specifically, there is a risk that investors place too much reliance on ratings because they have a governmental endorsement. Over-reliance on ratings by investors is already problematic, according to many, as discussed below. Thus, public policy should be wary of further increasing it.

Finally, with the government utility model, market-based mechanisms such as competition and reputation would not be effective to render the rating organization accountable for its actions. Accordingly, setting up a government utility to provide ratings would involve crafting effective accountability mechanisms.

In light of the issues it raises, the government utility model does not seem a suitable solution to address the failings of CRAs.

b) Registration Model
The U.S. and the E.U. have opted for a registration system pursuant to which rating agencies have to register with the competent securities commission. Registration conditions are established in rules of the relevant securities authorities, which have discretion in deciding whether or not to grant registration.

As registrants, CRAs become subject to regulatory requirements developed by the securities authorities. They are also submitted to oversight mechanisms that provide regulators with information, and enable them to conduct inspections and examinations. To sanction non-compliance with regards to requirements, the regulators must have enforcement powers to reprimand, suspend, cancel or restrict registration with respect to a particular CRA.

From an efficiency perspective, a registration system can be beneficial for new or smaller agencies to the extent that it provides them with regulatory recognition of their expertise and qualifications.186 By granting regulatory approval to new entrants, the system provides issuers with more alternatives, thereby boosting competition in the industry. Moreover, putting securities commissions in charge of the regulation and

186 COMMITTEE OF EUROPEAN SECURITIES REGULATORS, CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005, p. 40.
supervision of CRAs could enhance their accountability to the public thereby providing an additional bonding mechanism.

The registration system does raise concerns. Firstly, the beneficial impact of the system on competition is dependant on the registration system being finely tuned both in terms of the recognition criteria and the ongoing rules of conduct it imposes. With respect to recognition, a flawed framework can create significant barriers to entry for emerging firms given the mandatory nature of the registration system. In this respect, the U.S. reform has attracted mixed reviews. Some commend the initiatives taken since the adoption of the 2006 Act, stressing its emphasis on transparency and competition. Others doubt that the reform will have a real positive impact on the entry of new rating agencies. In the E.U., Amterbrink and de Haan criticize the proposed regulation for not stating explicitly what the registration requirements will be. Cinquegrana recognizes that the reform is likely to raise barriers to entry, but nonetheless considers it necessary to restore confidence in the production of credit ratings.

With respect to rules of conduct, regulators can rely on registration to impose requirements that will ensure that CRAs manage appropriately conflicts of interest. However, it is doubtful that regulators have the expertise to develop requirements that

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187 Committee of European Securities Regulators, CESR’s Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005, p. 45.


192 Committee of European Securities Regulators, Report by CESR on compliance of EU based Credit Rating Agencies with the 2008 IOSCO Code of Conduct, May 2009, p. 27 (noting some deviations with the revisions made to the IOSCO Code in 2008 with respect to conflicts of interest). See however Coffee, 305 (doubting the relevance of rules with respect to conflicts of interest).
can improve the quality of ratings. Further, regulatory involvement into this area could “stifle innovation in the rating industry […] since regulators would have difficulty keeping abreast of the flow of new products that are regularly developed in financial markets”.\(^{193}\) In the U.S., the regulation of the substance of ratings by the SEC is prohibited by legislation. In Europe, the reform seeks to do so as the regulation specifically deals with rating methodologies: “CRAs will have to use methodologies that are rigorous, systematic, continuous, and can be validated based on historical experience”.\(^{194}\)

Finally, registration can be seen by market participants as implying an official endorsement of ratings.\(^{195}\) This perception will particularly be present where authorities purport to regulate the substance of ratings. It raises two related concerns. Official endorsement could reinforce the over-reliance of investors on ratings by giving them an official quality seal. In addition, it may render regulatory authorities accountable to investors for the failings of rating agencies. From this perspective, in its report to the European Commission, the ESME stated that it did “not consider it possible for regulators to put themselves in a position where they can give that level of endorsement”.\(^{196}\)

There is a clear consensus forming around registration as the model to be used to regulate CRAs. Not only the U.S. and E.U. have opted for this model but the Group of Twenty (G20) has also clearly sided with it, agreeing that “all Credit Rating Agencies whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration”. Nonetheless, the registration model is not flawless and


\(^{196}\) EUROPEAN SECURITIES MARKETS EXPERT GROUP, Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 22.
the European approach raises the risk of imposing a burden on rating agencies that may not be offset by the benefits generated by tighter regulation.

c) Disclosure-based Model
Following an approach advocated by this author, the CSA have proposed a weak form of registration that rests on a disclosure-based model. Pursuant to this model that has recently been implemented in Australia, regulators would require that “approved credit rating organizations” disclose their codes of conduct to the public and indicate to what extent their provisions are consistent with the IOSCO Code. Where the provisions of a CRA’s code of conduct would deviate from the Code’s provisions, the agency would have to explain where and why these deviations exist, and whether such deviations nevertheless achieve the Code’s objectives.

Generally speaking, the comply or explain model can be an effective mechanism to assuage concerns over CRAs’ lack of accountability. Mandatory disclosure about codes of conduct may exert additional disciplinary pressures on rating agencies. Disclosure can assist investors in ascertaining the reputation of CRAs by permitting them to identify those that have adequate mechanisms into place to protect against abuses. Investors’ assessments can then be reflected in overall appreciation of the credibility of the ratings. Where investors doubt the accuracy or independence of ratings, issuers would tend to avoid the latter and seek a more credible agency or alternate mechanism to signal their creditworthiness.

In addition, to ensure that the comply or explain model is effectively respected by CRAs, securities commissions would take formal jurisdiction over rating agencies.


According to the CSA Consultation paper, the regulatory change proposed would grant oversight powers to securities commissions with respect to CRAs. Thus, an approved credit rating organization would be obliged to provide securities regulators with information about its business and its compliance with the Code of Conduct, as well as any other information, books and records related to its rating activities. An approved credit rating organization would be required, where a securities regulator would consider it necessary, to submit a review of its practices and procedures and its compliance with the Code of Conduct. Following such a review, it would have to make any changes to its practices and procedures relating to its business as a CRA that are ordered by regulators. Ultimately, CRAs would be subject to the commissions’ power to take decisions in the public’s interests which could be used to impose terms and conditions on their conduct of business.\footnote{Ontario Securities Act, R.S.O., c. S-5, s. 127.} In particular, regulators would have the power to revoke, amend or modify a CRA’s designation as approved credit rating organization.

As the CSA point out, the disclosure-based approach would provide a mechanism that fosters compliance with the IOSCO Code of Conduct. It would be a cost-effective alternative to creating a comprehensive registration regime. Further, this approach would avoid overlapping regulation of CRAs while giving the CSA authority to impose changes if necessary.

In light of the transparency issues underscored by the credit crisis, the comply or explain approach would need to be supplemented by mandatory disclosure requirements with respect to ratings and rating process. The requirements, which could be modeled on the provisions of IOSCO Code of Conduct, should seek to ensure that market participants have the relevant information to assess the value and meaning of ratings. While a comply or explain approach is desirable for issues pertaining to governance arrangements, it appears less satisfactory to provide the relevant information to judge ratings and rating agencies performance. And even though rating agencies have recently enhanced their practices,\footnote{See DBRS, DBRS Commitment to High Standards and Continuous Improvement, July 6, 2009.} imposing mandatory disclosure requirements would yield benefits in terms of compliance and standardization that would likely offset the costs associated with mandatory disclosure.
In addition, the CSA should revise their definition of “approved credit rating organization”. Indeed, the designation of specific rating agencies as “approved rating organizations” is not without significance. It bolsters the reputation of these agencies by giving them regulatory imprimatur. Moreover, it creates a potential barrier to entry for new firms which cannot act as rating agencies so long as they are not recognized by regulators and so long as the regulation has not been amended. The fuzziness surrounding the recognition process and criteria exacerbates the problem facing new entrants.

This approach must be considered in light of two caveats. Firstly, disclosure is not a panacea, as many have noted. Professor Schwarcz notes that disclosure may not be an effective tool to deal with complex financial instruments, as it “may well be too detailed for many […] to understand or assimilate, or too superficial to allow investors to fully assess the transaction and its ramifications”.203 In the case of ratings, the adequacy of disclosure is further challenged by the existence of limits as to how transparent CRAs can be. Some of the information CRAs receive from issuers or sponsors to rate securities is confidential and cannot be disclosed to the public. Further, since the proprietary methodologies and procedures of CRAs must inevitably be kept private as they form the basis of their competitive advantage, investors will be deprived from information to assess the behavior and performance of CRAs. Even if those barriers can be overcome, some argue that resources, lack of sophistication and cognitive biases hamper the ability of investors, including institutional investors, to understand the CRAs’ disclosure so as to inflect market discipline where appropriate.204

The second caveat involves the impact of the disclosure strategy on competition. It must be acknowledged that disclosure obligations will have little positive effect on entry. New rating agencies may derive some reputational gains from disclosing their codes of conduct. Still, in the absence of a track record, the reputational gains will likely remain marginal since investors and issuers are more concerned with the effectiveness of the agency with the assessment of credit risk. If there are no new entrants, issuers will remain


204 But see “Signs of Capitalist Life”, The Wall Street Journal, July 17, 2009 reporting that Credit Suisse sold mortgage-backed securities with no government guarantees and no opinions from the credit-ratings agencies.
faced with the same choice of rating agencies. This caveat underscores the need to review the regulatory use of ratings in order to allow entry by new or small rating agencies as well as ensure the availability of alternate rating mechanisms.

CONCLUSION
In the wake of the financial crisis, CRAs have been criticized for having played a significant role in the market turmoil because of the particularities of structured finance products which made investors particularly dependent on ratings. Specifically, a number of failures on the part of CRAs have affected the quality and integrity of the rating process. Investor confidence in CRAs has been badly damaged. Lawmakers and regulators have been urged “to do something” to improve the accountability and effectiveness of CRAs.

As this paper shows, the problems that affect CRAs are well-known having been identified by a number of academic studies and governmental reports. There is also a strong consensus that regulatory intervention is warranted to redress the deficiencies that affect the rating process and ratings. This paper argues that the market failures that affect the credit rating industry support the case for regulatory intervention. However, what form should such intervention take is less clear.

The Group of Twenty has advocated the implementation of a registration system to ensure the oversight of CRAs. As this paper shows, registration systems can have a variety of intensity. The European Union has put forward a registration system that will impose significant regulatory requirements with respect to every aspect of CRAs’ activities. In the U.S., the SEC is buttressing its registration system based on the NRSRO status by adding disclosure obligations and prohibitions on conflicts of interests. While the American approach leaves room for competition, the European Regulation does not pursue that avenue and, in fact, risks raising barriers to entry. Since we consider that market-based instruments have a place as disciplinary mechanisms, we do not favour the European solution as it may well stifle competition.

The Canadian Securities Administrators propose a light form of registration based on a comply or explain model. Despite the disturbing failings of CRAs, it remains the option that is the most adapted to the Canadian environment. It introduces regulatory
oversight while preserving a role for market-based instruments. At the same time, it avoids duplicating the regulatory initiatives set forth in the U.S., a result that is commendable given that the American debt and asset-backed securities markets dwarf their Canadian counterpart.