Whither Credit Ratings Regulation? A Case for Regulatory Monitoring

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Abstract: if history is any guide, there are two concerns that may bring a regulatory move towards credit ratings. First, there is the concern that stems from the use of these privately issued ratings by financial regulations. Secondly, there is a liability concern that comes from the involvement of ratings in the advent of financial difficulties. The former has proved a poor incentive while the latter has brought oversight strategies. Setting up mandatory rules, one should however not forget that these would not have been necessary if the use of ratings by private agents had proved more informed. To prevent unchecked reliance should be better identified as a policy response and since regulatory bodies use ratings in the first place they are entitled to implement a regulatory monitoring framework that would focus on the overall consistency of ratings. To ensure efficiency, this critical activity should be centralized and publicized.

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Today financial markets heavily rely on independent debt evaluations known as “ratings”. Some firms evaluate debt issues and issuers to provide the investing public with letter grades, the main value of which are reliability and simplicity. Though for a long time an American bond market feature, these ratings have by and by become requirements to enter global capital markets. They have also played a consistent role in the commoditization of credit risk, which has been a driving force of recent financial markets developments. In the early summer 2007, structured finance ratings started to experience a wave of downgrades, unprecedented both in size and in severity. From then on, rating firms have been under constant fire and heated debates on the regulation of the rating business have taken place, to which this paper aims at bringing some hindsight.

As opposed to a broad normative discussion on why ratings should be regulated, here the methodology is purposely empirical. Focusing on how regulation regards ratings as a concern and reviewing the existing experience, there seems to be only two arguments capable of motivating regulatory action: (i) ratings should be regulated because regulators use ratings and (ii) ratings should be regulated because they should be held liable for their mistakes. Of course, regulators will go one step beyond and secondary arguments will step in. The most successful have so far been: (a) the oligopolistic nature of the rating business and (b) the existence of vested interest conflicts in the leading rating business model. From a normative point of view, here starts a true debate… yet one should not forget that these matters failed to bring regulators to act on their own.

In the first part of this text, each reason will be introduced with the help of existing experiences and then evaluated as an incentive for regulators. This approach is leading to consider (i) as a poor incentive when (ii) may lead to oversight strategies. Building on this analysis, one may better understand the current regulatory moves. Also, as in the second part of this text, one may use such a preliminary analysis in order to discuss the pertinence of these moves. This goes along with advocating that regulatory action focuses on monitoring the overall consistency of privately issued ratings.

1. Background Information: Regulation and Ratings in History

Sylla (2002, pp. 1-7) pointed out that bond markets existed for over 300 years without privately issued ratings. Paying attention to this led to highlight how the birth and development of ratings in the 1910s and in the United States came from the previous "American invention" of a corporate bond market. When the use of ratings became more and more global over the last quarter of the twentieth century, the American experience still provides the major source of background information.

1.1 Concerns over the use of ratings in regulation

American financial regulators started to use ratings in the 1930's, mainly following market practices using ratings in order to deal with agency problems. The Federal Reserve had developed procedures relying on ratings while several state insurance regulators experienced on their own (see Harold (1938, 3 p.25) and Moody's (2004, p.3)). The decision to use ratings in one of the key regulatory moves on the wake of the Great Recession meant a change of scale and then drew a little more public attention.

When the 1936 Banking Act had specified that all national banks were subject to the orders of the Comptroller's Office as for the securities they might purchase, the Comptroller issued a ruling stating that "the purchase of investment securities in which the investment characteristics are distinctly and predominantly speculative, or investment in securities of a lower designated standard than those which are distinctly and predominantly speculative, is prohibited" and adding in a footnote that "the terms applied herein may be found in recognized rating manuals" (see Harold (1938, p. 30)).

This decision spurred confusion about what the footnote exactly implied and hostility about the use of bond ratings as tools to influence the structure of commercial banks portfolios. The Comptroller had then to state that ratings were not "the sole criterion, or even a necessary criterion, for judging whether or not a particular bond was eligible for purchase by a national bank"[2]. Controversies did not quiet down and the footnote was even quietly deleted on July 1 1938… within days, however, all US banking regulators published a joint resolution on a procedure for valuing bonds in bank portfolios unambiguously relying on bond ratings.[3]

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[2] Address by J. F. O'Connor before California Bankers Association, May 22 1936

[3] The procedure was book value for bonds of Group I (Aaa to Baa inclusive); current market value plus any unrealized 50 cent depreciation on them should be charged against net bank capital for Group II (Ba or below) (See Federal Reserve Bulletin, 24, 565, US Fed Reserve Board, July 1938))

This time controversies did quiet down but this official use of privately issued opinions was fundamentally problematic because the act of public delegation was incomplete[4]. Nonetheless, over time the reliance on ratings would be incorporated to federal securities law, to a wide range of financial legislation under the one of the Congress and even to a number of other federal and state laws (for an overview, see (SEC (2003a, p. 6)). Surprisingly, it is not questions about the delegation that would bring US officials to wonder about the regulation of ratings but a problem of coherence: neither the joint statement nor the following rulings using ratings did clearly state whose ratings they were referring to…

The limited market structure of the rating business had enabled a convention to emerge and financial rules came to be interpreted as pointing to the ratings provided by market leaders (S&P, Moody's and Fitch). In the early 1970's and in what should have been just another financial rule referring to ratings, the Securities Exchange Commission (SEC) became the first regulatory body to designate which ratings had to be used[5]. These were the ratings provided by Nationally Recognized Statistical Rating Organizations (NRSRO). The SEC however left the definition of this official status pending by merely stating that it would be granted to credit rating firms with relevant market recognition.

In the early 1990's, the SEC finally raised the issue of an appropriate regulatory treatment of rating firms *given the use of rating in financial regulations*. The agency considered: (a) ending reliance on NRSRO ratings by SEC rules; (b) going on with the current regime; and (c) implementing more direct and expanded oversight of credit rating agencies (see SEC (1992 a, b, c, d & e)). By not reaching a consensus and by not taking actions, the SEC chose to remain with the existing system… From 1992 to 2005, the SEC repeatedly voiced the possible need of NRSRO overlook and procrastinated[6]. One may make sense of this attitude by noting that: (i)

[4] Although it has never been brought against the use of ratings in financial regulation, a law scholar may point to cases of law in the United States challenging the constitutionality of some delegation to private regulators (see Partnoy (1999, note 29 p. 627)).

[5] See the 1975 Net Capital Rule (Rule 15c3-1, 17 C.F.R. § 240.15c3-1, setting new net capital requirements for broker-dealers).

[6] See SEC (1994) soliciting public comment on the appropriate role of ratings in the federal securities laws, and on the need to establish formal procedures for recognizing and monitoring the activities of NRSRO; SEC (1997) proposing to amend the Net Capital Rule in order to define NRSRO; SEC (2002a) looking to ascertain the role of credit rating agencies in the U.S. securities markets, and to aid the Commission in assessing whether to continue to use credit ratings in its rules and, if so, the categories of acceptable credit ratings and the appropriate level of regulatory oversight. This was followed by hearings on the same broad subjects (SEC (2002b)) and by seeking comments on: (i) possible alternatives to the current NRSRO designation, (ii) criteria used to recognize firms as NRSRO, (iii) examination and oversight of firms, (iv) conflicts of interest, and (v) alleged anticompetitive, abusive and unfair practices (SEC (2003b)). Lastly, SEC (2005) proposed a new definition of NRSRO.

given the use of ratings by other regulatory bodies, it is not obvious that the SEC had the legitimacy to freely rule on the use of ratings in regulation and (ii) given its mandate, it is not obvious that the SEC had the legitimacy to undertake the regulation of rating agencies.

Overall, the interesting point is how the regulatory use of ratings proved a poor incentive for a regulation of ratings. This issue is best illustrated by the attitude of the SEC but what made this attitude so important is the generalized passivity of all the other regulatory bodies using ratings in the first place. When one may argue that this passivity could be peculiar to the American case, more recent experiences abroad does not support such a view (see (IOSCO (2003, III B 2/ vs III B/ 3/)). Musing on the Basel II framework for banking regulation, one could then prophesize little regulatory pressures towards privately issued ratings. Consider that the Basel II reliance on privately issued ratings is weaker than in any of the cases introduced above[7]. Indeed, as for now, the ECAI designation has remained a poor incentive for rating regulation (see, e. g., CEC (2005, pp. 6-7)). A blunt and public acknowledgment of this point came with the ongoing initiative for a European registration framework for firms providing ratings, which did not even consider the existence of the ECAI category as a regulatory option (see EC (2008)). Mentioning this initiative leads to the second major source of regulatory pressure towards the rating business.

1.2 Concerns over liability

A rating is by definition a prospective assessment of credit quality. From an investor point of view: the higher the rating, the higher chances are to be repaid in full and due time. Then, any credit quality deterioration of a rated security is a reputation test for firms providing ratings: to what extent did they anticipate such a bad outcome? A “rating failure” occurred when the answer turns out to be negative. While every rating failure is a threat to rating firms’ reputation, none can provide an unambiguous case… the argument for ratings regulation has then to move to broader concerns: overall accuracy and stability of ratings, inappropriate design of the rating business, etc.

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[7] In 1999, the Basel Committee set up a new capital adequacy requirement proposal including the use of credit risk evaluations provided by recognized External Credit Assessment Institutions (“ECAI”). The ECAI concept was mainly motivated by acknowledging the usefulness of ratings and then a huge part of the debate on the Basel II proposal has focused on the relevance of a use of ratings in regulation (see BIS (2000)). This discussion aside, the Basel II framework ended up relying on ECAI in only one of the alternatives for calculating capital requirement (in the other one, credit risk is calculated by an internal rating system) (see BIS (2004)). Moreover, even in the standard case, external assessments remain inputs in the evaluation from the relevant regulatory body and experience will show the weight these bodies will give to this input. Last but not, the ECAI term leaves open the possibility to include other sources of information than traditional rating firms. As for the European Union, a designation framework orchestrated by the European committee of banking supervisors (CEBS) was put in place.

But this second level of discussion should not be misleading: every time the primary concern is the liability for rating firms for their role in the advent of severe financial difficulties. With a background of public outcry and with rating firms escaping formal liability in courts thanks to a number of key features of their business[8], such a belief is likely to prove a powerful incentive for regulatory action: "rating agencies will not go on as if nothing had happened".

The 2001 wave of US corporate scandals heavily activated such a liability concern. From the start, rating agencies were somewhat protected from a true indictment thanks to the extended accounting data falsifications. Yet the perspective of letting rating firms run their business as usual when they had kept investment grade ratings weeks before these major bankruptcies was unbearable. The core goal of regulators was then to bring the rating business under control[9] and they undertook oversight in two ways: one can be considered as open and weak while the other is best described as hierarchical and strong.

1.2.1 Open/weak oversight

In 2003, the technical committee of the global reunion of security exchange regulators prepared a report on the activities of credit ratings firms, followed by a statement of principles (IOSCO (2003a&b)). Noting the extended reliance on credit ratings by market participants and regulators, regulators from all over the world agreed to ensure a greater reliability of credit ratings by overseeing credit rating activities and by undertaking this oversight in an open and global way: a code of conduct focusing on "corporate governance" rules (IOSCO (2004))[10]. This code is open in its draft with an equal consideration of every stakeholder through the use of a questionnaire. It is also open in its application: rating firms are free to draft their own codes according to a "comply or explain" approach while regulators are free to: (i) incorporate the code or some of its

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[8] The main argument is that ratings are opinions published with a disclaimer stating that they are not an investment advice. Hence, rating agencies have proved highly successful in escaping formal liability. In the United States, for example, in a couple litigations following major defaults attempts to press charges against rating agencies on the ground of liability for rating failure remained unsuccessful (Washington Public Power Supply System (WPPSS) in 1983; Executive Life bankruptcy in 1991; Orange County of California in 1991, Commercial Financial Services in 1998, Enron in 2001). Of course, regulators could change their legislative framework in order to increase the formal liability of rating agencies. However, to date, regulators have never intended to act on this issue (see, e.g., the European Commission raising the issue of legislative framework evolution (CESR, 2005, Annex A) but not advocating actions (CEC 2005)).

[9] By *control*, I mean the strategy of waving the exercise of power in order to influence the behavior of an agent

[10] The IOSCO code aims at overseeing that credit rating firms: (i) ensure quality and integrity of the rating process, (ii) remain independent and avoid conflicts of interest, (iii) assume their responsibility to market participants through greater methodology transparency and adequate treatment of confidential information provided by issuers.

part to their regulation, (ii) monitor the implementation of the code or (iii) undertake direct regulation.

In the first two options, a regulatory body does not undertake direct regulation but profits from an opportunity of oversight activities. Nevertheless, it is acting and helps the IOSCO overseeing scheme to develop. Yet here regulatory action is "weak" in the sense that it is diluted in a broader scheme and that the exercise of power is limited. This is most evident in the option (ii), where regulators merely monitor the implementation of a scheme driven by self-regulation.

1.2.2 Hierarchical/strong oversight

Four days before Enron declared bankruptcy, this company was still rated as good credit risk. In 2002, the United States Senate held hearings on how this could have happened (Senate (2002a)). Then, in its broad report on Enron, the Senate stated that rating agencies displayed a lack of diligence in their coverage and in their assessment of this company[11]. The discussion on rating firms' performance led to broader issues: little formal regulation or oversight[12], low liability granted under several regulatory exemptions[13]. The Senate ended up stating that the SEC, in consultation with other public bodies using ratings in their regulations, should set specific conditions to this official recognition through additional regulations and should monitor compliance with these requirements.

The SEC mainly answered by turning down the ability to assess Enron financial soundness and by pushing forward the rating firms' limited view of their information verifying role (SEC (2003a p. 32)). This answer however took place in a report required by the Sarbanes-Oxley Act[14], the

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[11] That is: by not asking probing questions and by accepting at face value the information provided by Enron officials; and by ignoring or glossing over warning signs and by failing to sufficiently consider factors affecting the long-term health of Enron, particularly accounting irregularities and overly complex financing structures (see Senate (2002b)).

[12] The Senate also stated that this conditions should include: (a) standards and considerations to be used by credit rating agencies in deriving their ratings, such as those addressing accounting issues; (b) standards for training levels of credit rating analysts (including training on the information contained in periodic SEC and other regulatory filings and training in basic forensic accounting) (Senate, 2002b).

[13] Most of all rating agencies are excluded from Regulation Full-Disclosure (F-D), which prohibits an issuer of securities from making selective disclosure of material information to certain individuals (any non public material information disclosed to them will have to be publicly disclosed) (17 C.F.R. § 243.100(b)(2)(iii)). Only NRSRO are excluded from civil liabilities for those attesting to the information contained in a registration statement (SEC Rule 436 (g) (17 C.F.R. § 230.436.), which was issued pursuant to section 11 of the Securities Act of 1933).

[14] The SEC was required to provide a report on: (A) the role of credit rating agencies in the evaluation of issuers of securities; (B) the importance of that role to investors and the functioning of the securities markets; (C) any impediments to the accurate appraisal by credit rating agencies of the financial resources

original purpose of which was less influenced by the Enron case: to what extent the role of rating agencies is an issue for the functioning of securities markets? Why would firms not provide reliable ratings (because of limited competition, because of interest conflicts, etc.)? and what should be their role in the financial information dissemination scheme? With these questions in mind, the SEC answer had a disappointing overall purpose of interpreting the new regulatory trend under the light of the agency's older perspective (see, *supra*, section 1.1)[15].

The Sarbanes-Oxley Act was however no end of the story: in 2003, the Congress started to hold hearings on the broad issue of ratings regulation (see Congress (2003 and 2005a&b)). When these hearings focused on the SEC lack of legitimacy in order to ensure a broader monitoring role of rating agencies, the SEC director of Market Regulation acknowledged and a SEC document outlining how a legislative framework would enable the agency to perform oversight and regulation of credit rating agencies was requested (Congress (2005b)). This was followed by the introduction of a bill to regulate the rating business to the United States Congress (Congress (2005c)). When the Congress held hearings on the bill, the SEC document was inserted to the record and clearly backed the proposal (Congress (2005d)). At the end of the summer 2006, the Credit Agency Reform Act was passed and by the end of spring 2007 the SEC had adopted a set of rules to perform a now mandated registration and overseeing role (see SEC (2007)). The strength of this move may be linked to a continuous reminding of the original liability concern.[16]

1.3 Regulatory discussions on the wake of the structured finance episode

Focusing on a liability concern as an incentive for regulatory action, the lines above outlined two types of oversight strategy between which the European authorities switched over the past

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and risks of issuers of securities; (D) any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers; (E) any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; (F) any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate the consequences of such conflicts. (Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 702(b), 116 Stat. 745 (2002))

[15] An extensive part of the report is dealing with introducing this perspective (see SEC (2003a, pp. 6-12; 18-24)), while the required answers heavily draw on information gathered under these own SEC initiatives and while most of the SEC statements are commitments about the NRSRO status improvement. Indeed, the SEC went on seeking comments and proposed a new NRSRO definition (SEC (2003b&2005)).

[16] See, e. g., Rep. Fitzpatrick, in its opening statement to the hearings on the final bill (HR 2990): « [E]very American remembers the financial hardships they faced when WorldCom and Enron went belly up. I certainly remember the broken investment accounts of my constituents and the people of Pennsylvania's 8th Congressional District. And it is extremely troubling that little known players in this crisis, Moody's and S&P, rated Enron and WorldCom at investment grade just days prior to the filing of their bankruptcies.» (Congress (2005b)).

years[17]. The last move of the pendulum is now under way and follows extended public outcry over the central role that ratings played in structured finance.

This role brought a number of critics that preceded the crisis of structured finance (see, e. g., Partnoy (2005) and especially Mason &Rosner (2007, pp. 34-47)). Overall, structured finance was a new field for rating organizations and it brought unprecedented fragility to the rating system that they provide to the investing public. The self correcting actions that have been going on from the summer 2007 confess how the consistency of this system suffered. Rating firms have proved slow to move their grades in front of market developments and late in adjusting their methodologies against mortgage securitization dynamics.

These firms can follow two different business models: either investors pay for getting access to these privately issued opinions or issuers pay for getting their security rated. Overall the global rating business is however heavily dominated by three firms mostly charging securities issuers (Moody's, S&P and Fitch). Basic cases against rating firms have then focused on greed. Since the early 1970's, the three market leaders have chosen to be paid by issuers then any of their major failures would bring charges against: (a) their inherent conflict of interest and (b) the oligopoly structure of the rating industry. These recurrent concerns found the most fertile ground in the structured finance field but (again) no significant regulatory move came before the advent of a global crisis born out of problems with structured finance securities. When blaming rating firms has become a favoured sport, it takes a little more to find them guilty. Most legal commentators find the fortune of the numerous court filings brought against rating firms is hard to predict...[18]

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[17] The first time the European regulator considered the issue of rating agencies was clearly linked to the Enron scandal (which drove the European Commission commitment to analyze the issue at the Oviedo Informal ECOFIN Council (April 2002)). A substantial move toward action came in front of the European Parliament through the form of an own initiative report recommending the creation of a supervisory European Union Ratings Authority with which agencies would be required to register (CEMA (2004)). The European Parliament considered the report but only resolved to ask the Commission and the Committee of European Securities Regulators (CESR) to look at the issue and make recommendations by 2005, July 31st (EP (2004)). With the *Parmalat* scandal came another highly publicized case of rating failure, this time at home (March 2004). In July 2004, the Commission asked the CESR to provide technical analysis and advice to assess the need for introducing European legislation or other solutions. Four issues were identified : (i) potential conflicts of interests within rating agencies; (ii) transparency of rating agencies' methodologies; (iii) legal treatment of rating agencies' access to inside information; (iv) concerns about possible lack of competition in the market for provision of credit ratings (see CESR (2005, Annex A)). The CESR did not consider (iv) as well founded and contested both the relevance of any regulation intending to deal with (iv). It also advocated the reliance on the IOSCO initiative for dealing with (i) and (ii) (CESR (2005)). The Commission followed the advice (CEC (2005)). Lately, the pendulum went back to oversight as will be shown in the next section.

[18] See, e. g., "Moody's and S&P rating litigation an uphill battle for plaintiffs", by J. Antenen and C. Montoto, provided to Financial Times readers by www.dealreport.com on 12/10/2008.

Such a climate activated the liability incentive introduced above. In September 2007, a US Congress committee held hearings on the role of rating agencies in subprime mortgage securitizations. The SEC was questioned on its implementation of the 2006 Credit Rating Agencies Reform Act while all participants were asked on the necessity of further regulatory proceedings. The head of the SEC mainly answered to representatives by stating that a thorough review of major rating firms was under way (see Congress (2007)).

In June 2008, the agency published a mandated annual report on NRSRO, which not surprisingly advocated a number of changes in its implementation of the Credit Reform Act in order to deal with issues evidenced by the structured finance episode (SEC (2008a)). A public request for comments quickly followed and, in early July 2008, the outcome of the SEC investigations was finally made public. To some extent, SEC (2008b) portrayed rating firms far more concerned by their business growth than with model accuracy. Congress hearings in October 2008 exploited this material and the SEC voted on a number of final rules on NRSRO in early December 2008. In other words, strong/hierarchical oversight has been reinforced while some predict more actions will follow.

Turning to the "old" world, in September 2007, the European Commission asked the Committee of European Securities Regulators (CESR) to extend its scheduled review of rating agencies' business codes to their role in structured finance. About 9 months later, CESR (2008) advocated coping with the IOSCO framework and adding an industry based body dedicated to its implementation. But in the meantime hierarchical oversight had gained strong momentum under the leadership of Commissioner McCreevy and the French Presidency. The European Commission published a draft directive for public comments at the end of July 2008, which focused on mandatory registration of any rating firms operating in the European Union. The final draft is now waiting to be discussed in the EU parliament (see CEC (2008a&b)).

While a detailed discussion may focus on the relevancy of each advocated rules, the present analysis merely points to the fact that the recent initiatives are above all moved by a liability concern. This explains why strong hierarchical oversight strategies prevail. These strategies of course raise the issue of undue regulatory interferences. This is a pervading question for any detailed analysis of the rules. More broadly, the next section will challenge the belief that such oversight strategies are all that is needed.

2. A Case for Regulatory Monitoring

Challenging the overall relevancy of oversight strategies born out of liability concerns means nothing else than extending the blame game to rating users. This does not mean that these strategies are not welcome in order to enforce better rating practices, this simply pays attention to the fact that none of these will ever bring fool proof ratings. In line with the historical perspective outlined in section 1, it is then argued that use of ratings by financial regulators provides a poorly exploited avenue to fight naïve uses of ratings.

2.1 Regulatory monitoring and the liability incentive

Interest conflicts may well have fuelled a number of mismanagements revealed by the 2007/2008 crisis, yet there is no certainty that investor paid rating firms would have passed the test of the structured finance episode. First and foremost, the reputation of major rating firms suffered on the wake of the 1929 crisis and they were all paid by investors at the time (see Harold (1938, chapter 6-10)). Secondly, investor paid rating firms are not exempt from potential interest conflicts (see SEC (2008b, note 55 p.10) for an official statement).

Acknowledging these two points does not mean being blind to recent errors by rating firms and deaf to the interest conflict argument. This means being aware that these errors were also fuelled by investors failing to check on structured finance ratings. Introducing the literature on financial crises and sorting out new factors about the 2007/2008 crisis from traditional ones, Calomiris (2008, pp.19-34) comes back on the mistakes of major rating firms but brings forward the complacency of investors as a striking feature and ends up pointing to the critical role of the principal-agent relation between asset managers and final investors.

Responsible investors should have gone beyond ratings. Provided that investors had failed to perform such a control, regulators should have attempted to orchestrate it. A 2005 Bank of International Settlements report welcomed the fact that rating agencies did not prove overly conservative in front of structured finance dynamism a couple of pages after showing how difficulties with manufactured housing Asset Backed Securities (ABS) had brought a crisis in 2004 (see BIS (2005, 2 p. 24, 3-4 p. 27 and appendix 5 p. 51)). To some extent, here is a proof of a failure to initiate reforms after an episode had clearly evidenced an unfortunate chain of events with ABS securities. More broadly, when Reiss (2006) portrays rating firms as unaccountable standard setters for structured products that would have unduly influenced state regulatory initiatives, this can hardly fail to draw attention on an even more guilty passivity of US federal regulators.

How can an informed use of ratings be secured? An issue with the current oversight initiatives is that they generally assume that disclosure by rating firms is enough. Beyond tailored measures against basic mismanagements, this translates into requiring registered rating organizations to provide a number of transition statistics. When regulators strongly intervene on the way rating firms deal with their business, the task of assessing the overall performance of the rating system is left pending.

This is hardly welcome considering that one may indeed argue that recent events prove that such a task has to be institutionalized. Of course on the wake of market disruptions, the first option that comes to mind is that assessing the overall performance of rating system should be made public. This is something that even strong oversight strategies have set away, for one reason: this could annihilate any liability arguments since any rating system would have been officially approved. This is a problem when assessing credit over long term horizons deals with radical uncertainty: the new regulatory monitoring may be all wrong…

2.2 Regulatory monitoring and the regulatory use of ratings

But financial regulators are using ratings in the first place in a number of their rules and here lies a definitive argument for regulatory monitoring by public bodies. There, one should remind from section 1 how the regulatory use of ratings has been shown a poor incentive. This holds for any true action towards regulating the rating business and this unfortunately holds for monitoring the performance of rating system: financial regulators using ratings in many places should have had a closer look on what was going on with structured finance ratings. If all the concerned regulatory bodies had publicly brought pressure on major rating firms to get more transparency, they could have hardly resisted.

On the wake of the structured finance episode, a common trend has been to regret that the use of ratings by regulators had fostered investors' over-reliance on ratings. The SEC has even launched a proposal that would remove any reference to ratings in its rule. This is an exit strategy that the agency had been mentioning for some time, yet this was the first time that a detailed proposal would be drafted and made open to the public. When the SEC adopted final rules in December 2008, this proposal has however been postponed. This is not surprising since ending the use of ratings poses a heavy challenge to the future of financial regulation. Looking through the SEC proposal, in many instances the use of ratings would be replaced by requiring due diligence of the relevant actors, a strategy that could prove hardly efficient… To get a grasp of the costs involved, remember that such an exit strategy was of course known to US Congressmen on the wake of Enron and they ended up passing the Credit Rating Agency Reform Act.

One thing for sure is that the numerous uses of ratings in regulation have so far resulted in little monitoring of rating firms output. Yet, fundamentally, every time an organization externalizes a task it must develop a framework summarizing its need and guiding the way it will act towards its providers in the future. Were regulators to agree on the creation of a public rating agency, this law would hold… it may then be even more crucial since all agents would consider the evaluation provided with a definitive seal of approval. Overall, the passivity of regulatory bodies using ratings has been shown and then it should be fought by centralizing a framework a framework that would monitor the consistency of ratings across asset classes, geographical zones and time.

2.3 Which regulatory monitoring?

At the heart of the 1997-1998 Asian crisis, rating firms' sharply adjusted their evaluations of countries like Indonesia, Korea, Malaysia and Thailand. This in turn raised concerns about the accuracy and stability of sovereign credit ratings for many emerging markets. The IMF stepped in with a review of the role of credit agencies in global financial markets as well as the specific experience with sovereign credit ratings for emerging markets during the 1990s (see, respectively, IMF (1999, Chapter V and Annex VI)).

Discussing the role of rating agencies during the Asian Crisis, the IMF produced an empirical study using a set of variables to follow the relation between sovereign ratings and fundamentals and reviewing rating and market dynamics during the crisis (see IMF (1999, Annex V pp. 110-136). Further, this analytical effort went along with a discussion of the relevant criteria to evaluate rating agencies performance and with a survey of the leading rating agencies (focusing on information sources and access, analytical approaches and methods, and resources devoted to the analytical process) (see IMF (1999 (Annex V, pp. 136-145 and pp. 145-150)[19].

In other words a regulatory body primary moved by a liability concern ended up sketching what could have become a true monitoring framework focusing on ratings performance and mainly based on watch and blame (since deprived of any oversight authority). To my knowledge, this framework has not been followed up. In any case, it had a limitation since it meant being able to run a standard model of rating determinants for every case of sovereign rating. Manageable in the limited universe of sovereign issuers, this could hardly be followed in broader fields of rating activity.

A regulatory monitoring of ratings does not have to second guess the work of rating firms for every issue they rate, it simply requires that regulatory bodies formalize what they expect of

[19] Note that the IMF is clearly setting aside the comparison between the performance evaluation criteria it is building and the Basel proposal designation criteria (IMF, 1999, Annex V, p. 145).

rating firms. Every rating user has to be reminded that a rating is not an objective measure but a relative one. In other words, what matters is the overall consistency of rating grades over time, geographical zones and over asset classes. Of course this consistency is bound to fluctuate… by formalizing what is tolerable or not regulatory bodies will do nothing else than checking on the relevancy of their use of rating and meanwhile a monitoring of rating firms focusing on outputs will be enforced.

Over years of public bodies using ratings in their rules, to my knowledge, there have only been two cases of such a regulatory monitoring. The use of ratings in Basel II and the creation of the ECAI category has led banking regulators to agree on a formal ECAI monitoring process (see BIS (2004, Annex II)). An annex of the Basel II revised framework outlines a process focusing on 3 year cumulative default rates and setting public benchmarks that would (a) motivate a banking regulator to ask hard questions on a rating firm or (b) motivate a recalibration of the capital weights associated with the grades of the ECAI. Setting up a collateral policy using ratings, the European Central Bank acknowledged the ECAI category as for recognition and qualitative issues, it nonetheless created its own ECAF category that built on a separate monitoring framework (see ECB (2007), focusing on 1 year default rates and on the A rating grade).

These two frameworks are good examples to emulate. What is needed is nothing more than raising the issue acceptable default rate with rating grades. Then a process may be outlined by engaging a public framework that:

- Look at past frequencies
- Postulate a latent variable process
- Infer benchmarks from this process
- Define course of action when these are broken

But, once more, it should be reminded from section 1 that the existence of this kind of processes does not necessarily mean that concerned regulatory bodies will enforce them. This should motivate the creation of a body dedicated to this kind of exercise. Furthermore, according to Hornik *et al.* (2008), the more the rating systems monitored, the better (since using competing estimates of the same default probabilities provide a better basis for the latent variable process).

Concluding Remarks and Policy Proposals

While the reunion of global securities regulators has so far focused on codifying business practices (see IOSCO (2008)), its implementation of international financial reporting standards could easily lead to the creation of a global database centralizing privately issued ratings (see (IOSCO (2007, p.7)). This is nothing more than pooling and archiving information that is already mostly publicly disclosed, yet this is critical. Not surprisingly the goal of democratizing the access to rating histories can be found in regulatory proposals on both sides of the Atlantic ocean (see SEC (2008a) proposing to require their disclosure on rating firms websites and EC (2008) proposing the creation of a central repository for ratings). A global public central database has the advantage of not necessarily involving disclosure of investor paid ratings and of requiring the birth of a body dedicated to provide tools for assessing how rating systems performs. Creating this body, a public mandate could easily set up a monitoring framework of rating consistency such as the ones outlined in section 2.3.

To one deeply convinced interest conflicts arguments, this proposal for reform is far too light and it is critical to hand the rating business to investor paid firms. One may fundamentally doubt of such an extreme strategy and outline that in any case the crux of the matter is to foster an informed use of ratings. Of course a way to foster such a use is to work on the competitive structure of the rating business so that the two business models are better balanced; but this is only a mean not an end. By creating a transparent and straightforward designation framework thanks to which ratings from new entrants would be treated as equal to the ones of the market leaders for regulatory purposes, the 2006 Credit Rating Agency meant to increase competition but failed to address the issue of balancing the two business model. The SEC has now identified such a need and recently opened for comments a proposal that would force any rating firms paid by an issuer to communicate relevant information to an investor paid rating firm. To go one step beyond, any financial rule referring to ratings could state that each type of ratings should be used. Well beyond the structured finance field, any rule using rating would aim at fighting the current oligopoly structure of the rating industry. And, again, the battle would be fought without the regulatory interference risk that the current strong oversight initiatives face.

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