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THE POLITICS OF REGULATING CREDIT RATING AGENCIES IN THE EUROPEAN UNION

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Abstract

Why did the European Union (EU) decide to regulate Credit Rating Agencies (CRAs), instead of relying on the revised rules agreed at the international level and the revised US law to which the main CRAs operating in the EU but headquartered in the US were subject to? This research addresses this key question concerning the multi-level governance of financial services using a 'soft' rational choice institutionalist framework. It is argued that the global financial crisis, acting as an exogenous shock, triggered three causal mechanisms that led to a new institutional equilibrium within and without the EU, namely the issuing of EU rules on CRAs.

Key words: credit rating agencies, European Union, regulation, financial services, political economy

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2002). However, relatively few scholars have used a non principal-agent based RCI to gather a better understanding of the making of public polices in the EU. The most recent exception is the soft RCI applied to a variety of EU policy-processes by Heritier (2007) and Tallberg's rationalist theory of formal leadership with reference to the Presidency of the EU (2006).

The assumptions of the soft RCI that frames this research are that policy-makers and stakeholders are rational utility maximisers, pursuing their own interests, in a policy context with imperfect information. The policy preferences of actors are primarily driven by political economy considerations, they are endowed with different power and resources, and their actions are constrained or facilitated by the institutional environment in which they interact. The players of the regulatory game – which includes both public and private actors - are located at different levels of governance (national, EU, international, including the US).

The *dependent* variable of the research is the establishment of EU rules on CRAs –hence, the process and outcome of rule-making in the EU. The *independent* variables are the policy preferences (or interests) of the main policy-makers and stakeholders, as determined by the costs and benefits ensuing from regulation for the actors involved and their power resources. The *intervening* institutional variables are the support (or lack of support) for rules on CRAs by the Commission, the EU Presidency in office, and a critical mass of member states in the Council of Ministers. The research identifies the global financial crisis as an exogenous shock, or an *antecedent* variable, that altered the bargaining power of the main actors and shifted the equilibrium of the game (i.e. regulatory framework) towards a new institutional outcome, namely the issuing of EU legislation on CRAs. The paper seeks to inductively tease out the causal mechanisms through which this has taken place.

The research is operationalised in the following way. First, the role of CRAs in the financial crisis is explained, outlining the antecedent variable that prompted the functional need for the revising the regulation of CRA and changed actors' bargaining power. Second, regulatory alternatives to EU legislation on CRAs are outlined, reviewing first the IOSCO Code on CRAs at the international level and then the US law on CRAs. This discussion is necessary because both sets of rules affect the activities of CRAs operating in the EU or whose ratings are used by issuers in the EU market. Thirdly, by tracing the regulatory process that led to the regulation on CRAs in the EU, the independent variables, namely the policy preferences of the main policymakers and stakeholders and their bargaining power are explained, as well as outlining the intervening variables within the existing EU institutional environment. Subsequently, the paper outlines the dependent variable, namely the establishment of EU rules and the most controversial issues concerning the content of such rules. Finally, the penultimate section teases out the causal mechanisms set in motion by the global financial crisis that tipped the balance in favour of the specific institutional trajectory of regulating CRAs in the EU.

To sum up, the CRAs have been blamed for of failing to spot the size and risk of the bad US housing debt that was resold around the world, causing multi-billion-pound losses. Securitised products awarded with the highest rating grade amounted to 75% of those rated by the rating agencies (Commission 2008b). It was the discovery of these losses – the so-called sub prime crisis - that caused the global credit markets to freeze up, spreading the financial crisis internationally. In turn, this led to a functional response in the revision of the existing rules worldwide, as they had manifestly failed to prevent the crisis.

4. The IOSCO Code of Conduct Fundamentals for CRAs

Internationally, CRAs are regulated by a voluntary Code of Conduct Fundamentals issued by IOSCO in 2004 (IOSCO 2004) and revised in 2008 (IOSCO 2008). As explained in Section 6, the compliance of CRAs with the Code has been monitored in the EU by the CESR. The Code works on a 'comply or explain' basis — i.e. credit rating agencies are expected to incorporate all the provisions of the IOSCO Code into their own internal codes of conduct. Where they choose not to do this, they must explain how their code nevertheless gives effect to the provisions of the IOSCO Code. The IOSCO Code is meant to be applied by rating agencies of all sizes and business models and in every jurisdiction. It is a market driven compliance mechanism.

The rather unusual step of having a voluntary code of conduct issued by an international regulatory body, the IOSCO, followed the IOSCO's publication in September 2003 of the 'Principles Regarding the Activities of Credit Rating Agencies' (IOSCO 2003). The Principles, which outlined high-level objectives, were designed to be a tool for securities regulators, rating agencies and other interested parties wishing to regulate the activity of CRAs. Following publication of the Principles, some commentators, including a number of CRAs, suggested that it would be useful if IOSCO could develop a more specific and detailed code of conduct giving guidance on how the principles could be implemented in practice (IOSCO 2004). In addition, a series of significant corporate failures, such as the collapse of the US energy group Enron, and subsequently the Italian dairy group Parmalat, drew policy-makers attention to the activity of CRAs, which had failed to spot problems in the companies concerned.

As with the principles that preceded them, the Code fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the interested public (interview, Madrid, April 2009). The Code contained rules on that very draw upon the substance of the principles, namely: the quality and integrity of the rating process; CRAs independence and the avoidance of conflicts of interest; and CRA responsibilities to the investing public and issuers (IOSCO 2004: 3). As explained by Philippe Richard, the secretary general of the IOSCO in a letter to the *Financial Times*, January 7, 2005. p.14

…it was always intended that the code fundamentals should be sufficiently flexible to accommodate the wide variations that exist between the legal and market circumstances that apply in different jurisdictions. Indeed, the advantage of this flexibility is that any jurisdiction that has the power and the need to do so may supplement the code fundamentals with additional regulatory measures or incorporate it into its own regulatory requirements.

As explained in the previous section, CRAs were heavily criticised for underestimating the risks attached to large volumes of mortgage-related bonds and collateralised debt obligations, which triggered the global financial crisis in 2007-8. Hence, a 'functional' revision of the IOSCO Code was deemed necessary, as the existing rules had been proven pute se. In Jar

the broad lines of its proposal on CRAs in June 2008[2] with a view to address conflicts of interest, quality of ratings and transparency. Many of the changes proposed mirrored changes made to the IOSCO Code. On 1 July 2008, the SEC also issued for consultation a series of amendments of the US legislation. The aim was to review all references to NRSRO ratings in US financial law on the ground that these references in the legislation might have contributed to an undue reliance on NRSRO ratings by market participants (*Financial Times*, 22 July 2008. p.11).

In February 2009, the SEC issued new credit rating rules that affect NRSROs' record keeping procedures, conflict of interest rules, annual reporting methods and disclosure practices (SEC 2009). Many of the revisions enacted were similar to the rules included in the proposed EU regulation on CRAs. The main difference between the two sets of rules concerned the registration and authorisation process and the potential extra-territorial effects.[3]

6. The process of rule making on CRAs in the EU

Prior to the proposal for a regulation on CRAs put forward by the Commission in November 2008, CRAs were only subject to Community legislation to a very limited extent. In fact, they were referred to in the Market Abuse Directive by provisions concerning the presentation of rating and the disclosure of conflicts of interest. They were also mentioned in the CRD with reference to the determination of risk weights relevant to the calculation of capital requirements (ESME 2008). CRAs needed to have the status of Eligible Credit Assessment Institutions in order for their ratings to be use to calculate capital requirements according to the CRD. The mechanism for such recognition was set up by the Committee of European Banking Supervisors in the implementation of the CRD.

Over the last decade, there had been some short-lived attempts to consider the introduction of EU legislation on CRAs. These attempts did not make much of an inroad for three main institutional reasons, which can be seen as intervening variables and which changed after the global financial turmoil. First, there was not a critical mass of policy-makers supporting them in the Council: whereas certain member states, first and foremost France and Germany, favoured regulating CRAs in the EU,[4] other member states led by the UK and comprising Ireland, the Netherlands and most of the Nordic countries opposed such rules (interviews, London, May 2007; Paris, July 2007; Berlin, April 2008; Rome, December 2007).

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[2] More information can be found at www.sec.gov/rules/proposed.shtml

Second, the Commission was also lukewarm towards the prospect of regulating CRAs in the EU and hence did not put forward legislative proposals (interviews, Brussels, May 2007). As pointed out during several interviews with policy-makers and stakeholders, the 'better regulation' approach of the Barroso Commission was often in line with the policy preferences of the Anglo-Saxon coalition, promoting 'light touch' regulation. Third, no EU presidency forcefully pushed this matter. Last but not least, there was strong opposition to EU rules from the main stake holders in the private sector, namely the CRAs, which held considerable bargaining power given the oligopolistic nature of the rating market.

Following the Parmalat scandal, a resolution of the EP (2003) and a report of the EP (EP 2004), the EP called on the Commission to produce an assessment of the need (if any) for legislative intervention in this field. In July 2004, the Commission asked the CESR to provide technical advice on this. The CESR concluded that overall, the substance agreed by the IOSCO Code that was issued in the meantime addressed the issues raised by the Commission's mandate (CESR 2005a, b). In line with the 'better regulation' approach adopted by the Barroso Commission and fully subscribed to by the Internal Market Commissioner Charles Mccreevy, no legislative proposal was put forward by the Commission at that stage (Commission 2006). The Commission asked CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis.

In September 2007, when the sub prime-scandal in the US was in full swing, the Commission asked the CESR to review the role of CRAs in structured finance and re-evaluate regulatory options in this area. The 2008 CESR report on CRAs, like the 2005 CESR report, continued to support market driven improvement, considering the IOSCO Code, which had been revised, as the standard to regulate CRAs (CESR 2008). A second report commissioned by the Commission to the ESME[5] also concluded against the introduction of legislation in the EU. Echoing the concerns of the CESR, the ESME concluded that 'Given the global nature of the business of CRAs and the existing US law, we have doubts as to whether the development of a separate EU law would produce any particular benefits. We think it is important that CRAs are subject to a global approach to their business… regulatory coop-eration in this sphere is essential to avoid duplication of effort' (ESME 2008). e 2 issuec45 -1.ESR, thwhetherrrib10.02 0 0 10.02 176.94 252.08038Tm(5)TjETEMC /P ‹MCI global

that CRAs should be subject to registration in the EU (Council 2008). The European Council called for a legislative proposal to strengthen the rules on credit rating agencies and their supervision at EU level in October 2008 (Presidency conclusion 2008). Influential MEPs also supported the regulation of CRAs in the EU (*Financial Times,* 8 July 2008. p.3). Indeed, the EP produced two own initiatives reports that discussed this matter (EP - Rasmussen 2007; EP - van der burg and Dăianu 2008).

In July 2008, the European Commission published two consultation papers concerning: a) a complete regulatory framework for CRAs (Commission 2008b), which included the draft proposal for a directive or regulation on CRAs (at that time the legislative format of the proposed EU rules had not yet been decided); and b) policy options to address the problem of excessive reliance on ratings (Commission 2008c). The Commission's draft viewed the revised IOSCO Code as the 'global benchmark' in terms of substantive requirements, but it argued that these rules needed to be made more concrete in some cases and to be backed by an enforcement system. Many of the proposals articulated by the Commission at this stage were retained into the official proposal for legislation, hence they are discussed in the following section. Here it is important to note that the

7. The content of the EU regulation on CRAs and the most controversial issues

According to the regulation eventually approved in April 2009, all CRAs whose ratings are used in the EU need to apply for registration through an application submitted to the CESR and jointly decided upon by a college of securities regulators. The college of regulators is also involved in the day-to-day supervision of CRAs. Registered credit rating agencies have to comply with rules designed to prevent conflict of interest in the rating process and to ensure the quality of the rating methodology and the ratings. CRAs operating in non-EU jurisdictions can issue ratings to be used in the EU provided that their countries of origin have a regulatory framework recognised as equivalent to the one put in place by the EU, or that such ratings are endorsed by an EU-registered CRA.[7]

There were four contentious points concerning the content of the EU regulation on CRAs. To begin with, there were the issues related to the competent authorities in the process of registration (authorization, monitoring/oversight, cancellation). The Commission's consultation document issued in the summer of 2008 proposed two alternative models, on which policy makers preferences were very much divided.

The first model prescribed the allocation of supervisory competences to the home competent authority. The involvement of the other competent authorities - the host competent authorities - was left open, though they would be entitled to recover their national competence in case of inaction or ineffective action of the home competent authority. This model was largely supported by the countries likely to be home countries, first and foremost the UK, as suggested by the response of the British Treasury to the Commission's consultation,[8] whereas it was regarded as somewhat unsatisfactory for the host countries (interviews, Lisbon, November 2008; Madrid, April 2009). One of the disadvantages of this model was the risk of diversity of application of EU law at the national level.

The second option combined the establishment of an EU Agency (the CESR or a newly created agency) responsible for authorization, whereas the home country authorities would be responsible for ongoing supervision. Amongst the vast majority of member states and within the CESR, there was little support for the creation of a new agency (CESR 2008b). Furthermore, countries traditionally wary of strengthening EU

[7] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/629&format=HTML&aged=0&language=

institutions, including the Lamfalussy committees, first and foremost, the UK (see Her Majesty's Treasury 2007), opposed a stronger role for the CESR.

Why was the allocation of power of authorisation and oversight so controversial? This was because, since the main CRAs are not European, if one considers factors such as their number of employees or size of operations in the EU, these agencies are based in London. Hence, the British Financial Services Authority would have the main role in supervising their activities in the EU (interviews, Lisbon, November 2008; Madrid, April 2009). However, this raises the thorny issue of the relationship between home supervisors and host supervisors, which is traditionally a bone of contention in the regulation of financial services in the EU (Quaglia 2008). One important difference as compared to the banking sector, is that countries such as Germany, Italy, Spain, Netherlands and Belgium, which are home supervisors for banks operating throughout Europe, would fit into the category of host supervisors of CRAs, which have their European headquarters in London.

The second controversial issue concerning the content of the EU regulation on CRAs was that several substantive provisions put forward in the initial Commission's regulatory approach were regarded as too detailed. For example, it required the competent authorities to gather information about the model used by CRAs, the quality of people employed etc. This criticism was articulated in particular (but not only) by countries that have traditionally been in favour of light touch, principle-based regulation, as evidenced by the response to the Commission's consultation of the British Treasury, the Swedish Finance Ministry, the Finnish Finance Ministry and by the main CRAs that took part in the consultation, namely Standard & Poor's, Moody's, Fitch, AM Best. Some private financial associations, such as the British Bankers Association, also expressed their support for principle-based legislation.

The criticism concerning the prescriptive nature of the Commission's proposal was also shared by several members of the CESR, regardless of their nationality, because national supervisors were worried about the practical implementation and enforceability of the rules proposed (CESR 2008b). As one interviewee put it, the initial Commission's proposal was 'Soviet style' (interview, Lisbon, November 2008). Moreover, the main CRAs (Standard and Poor's, Moody's, Fitch, AM Best), felt that some provisions would restrict the analytical independence of the CRAs for their ratings. They argued that EU rules should not regulate the substance of credit ratings and the methodology used by CRAs, but rather the principles and process that a CRA undertakes to generate a proper rating. This was also stressed by the British and Dutch finance ministries, as well as the committees of supervisors, CESR and CEBS.

Thirdly, and related to the previous point, there were some differences between the rules proposed by the Commission, the SEC rules and the IOSCO Code. On several issues, the EU proposal was judged as not being aligned with the US regulation on CRAs and with the IOSCO Code. In their response to consultation, the main CRAs argued that it would be unduly burdensome for CRAs to maintain different policies and procedures only

8. An overall assessment

So, why was the EU able to pass relatively quickly brand new legislation on CRAs, despite some unsuccessful past attempts and instead of relying on the revised IOSCO Code and the revised US law? The exogenous shock of the global financial crisis led to a new institutional outcome (or equilibrium), namely the creation of EU rules on CRAs, through three causal mechanisms. First, it triggered a functionalist response to the crisis: the existing regulation had patently failed, as evidenced by the crisis, thus the regulatory framework needed to be revised worldwide – and so it was. This causal mechanism had a global reach, hence it does not explain specifically why the EU decided to adopt its own rules on CRAs.

Second, the global financial crisis strengthened the bargaining power of policy-makers that had long been in favour of regulating CRAs in the EU. It opened a 'window of opportunity', which certain policy-makers, first and foremost France, which held the rotating presidency of the EU, were able to exploit, acting as 'policy entrepreneurs' (Kingdon 1984). Whereas France had long been in favour of regulating CRAs in the EU, other member states that in the past had not been very vocal on this matter came out in favour of legislation after the global financial turmoil (interviews, Paris, May 2009). This made it possible to have a critical mass supporting EU rules in the Council. Given the changed context, the Commission decided to propose legislation to regulate CRAs.

Some member states, first and foremost the UK and Netherlands, continued to oppose EU rules, favouring instead the voluntary compliance with the revised IOSCO Code. However, the light touch, soft law regulatory paradigm successfully articulated by the Anglo-Saxon coalition over the previous decade and to some extent embraced by the Commission in the regulation of financial services (Quaglia 2009) was very much in disrepute as a result of the financial crisis. This weakened the bargaining power of this coalition, silencing their opposition to EU rules on CRAs. The financial crisis also where the reform enacted by the SEC in early 2009 is judged by some as not going far enough, there are calls for the US to 'follow Europe's tougher rules' (Wharton 27 May 2009).

Conclusions

Regulating the activity of CRAs very much highlights the multi-level governance of financial services and the 'uploading', 'downloading' and 'crossloading' of rules across jurisdictions and levels of governance (international, EU and national). First, at the international level, the activity of CRAs has been regulated by the IOSCO through the Code of fundamentals on CRAs, issued in 2006 and revised in 2008. The rules of such a code have to a large extent been downloaded into the proposed EU legislation, albeit there were important provisions that were specific to EU legislation.

Second, in 2006 the US passed legislation on CRAs, which has been revised in 2009, partly downloading the revisions of the IOSCO Code. This in turn raises issues about the extra-territorial effects of US rules for CRAs operating in Europe and the prospect of an indirect downloading (or crossloading) of such rules in the EU. Third, there are the potential extra-territorial effects of the proposed EU legislation because the main CRAs are headquartered in North America and operate in Europe mainly through subsidiaries. This raises the prospect of an indirect uploading or crossloading of the new EU rules in non-EU jurisdictions, first and foremost the US.

In the multi-level governance of financial services the EU is emerging as a *regulatory power* in the aftermagulatorJ.epower

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