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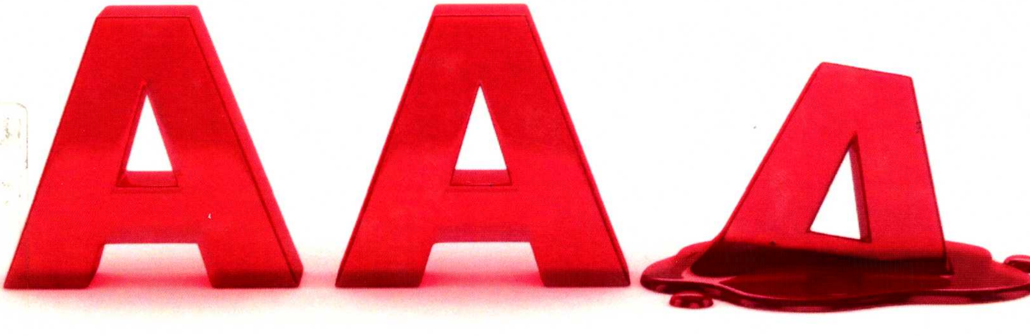
CREDIT RATING AGENCIES ON THE WATCH LIST

ANALYSIS OF EUROPEAN REGULATION



RAQUEL GARCÍA ALCUBILLA & JAVIER RUIZ DEL POZO

Credit Rating Agencies on the Watch List

Analysis of European Regulation

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JAVIER RUIZ DEL POZO

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For Javi, my enhancement.
For Sofía.

Preface

Ratings are, and have been, highly topical in the financial markets for the past few years as the role of rating agencies in the recent financial crisis has been heavily criticized; and the Euro debt crisis has placed agencies in the spotlight once more. Many academic studies, policy documents, regulatory initiatives, and newspaper articles have been produced on this industry, mostly highlighting the deficiencies of the agencies. We have drawn from this useful and extensive literature and from our experience as supervisors, to produce a book that goes a step forward by providing a comprehensive overview of all the key aspects of ratings and rating agencies.

Our work as rating agencies' experts in the Spanish Securities and Exchange Commission (CNMV) and in ESMA, has allowed us to be directly involved in all the discussions that have taken place in this regulatory sphere since 2003, when the functioning of rating agencies was mostly unknown to the markets and the possibility of regulating them was quite remote.

During these years of non-stop study and frequent journeys to work with our colleges of ESMA and IOSCO, we have had the opportunity to learn about the rating business and the regulatory problems that rating agencies' activities raise. In this learning journey, we have been accompanied by highly qualified professionals from the CNMV, from securities and banking supervisors from all over the world, and from rating agencies. We would like to thank these people for all the shared efforts.

We have done our best to capture in the book all the knowledge we have gained during these years and have tried to anticipate future developments. It has been a challenging task organizing the interesting debates, reports, and regulatory initiatives to produce a book that will hopefully be useful for users of ratings, regulators and supervisors, rating agencies, and for anyone interested in having a good insight into what rating agencies do.

This book would not have been possible without the wholehearted and constant support we have received from our 'triple-A' families and friends. Thanks to them, this complicated and time-consuming task has ended up being an enriching and fun experience.

Although we are currently working at the CNMV and have held until recently relevant positions in ESMA, the views expressed in the book are just ours and should not be reported as representing the views either of the CNMV or of ESMA. The book is based exclusively on publicly available information.

Raquel García Alcubilla
Javier Ruiz del Pozo

List of Tables

List of Abbreviations

ABCP	Asset-backed commercial papers
ABS	Asset-backed securities
AM Best	A.M. Best Company, Inc.
AMF	Autorité des Marchés Financiers
BCBS	Basel Committee on Banking Supervision
CDO	Collateralized debt obligations
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEREP	Central Repository
CESR	Committee of European Securities Regulators
CGFS	Committee on the Global Financial System
CMBS	Commercial mortgage-backed securities
CRA	Credit rating agency
CRAs	Credit rating agencies
CRD	Capital Requirement Directives
DBRS	DBRS, Limited
EBA	European Banking Authority
EC	European Commission
ECA	Export credit agencies
ECAI	External Credit Assessment Institution
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities Markets Authority
EU	European Union
Fitch	Fitch Rating, Ltd
FSB	Financial Stability Board (previously FSF—Financial Stability Forum)
G-20	The Group of Twenty Finance Ministers and Central Bank Governors
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
MiFID	Markets in Financial Instruments Directive
Moody's	Moody's Investor Services, Inc.
NRSRO	Nationally Recognized Statistical Rating Organizations
RMBS	Residential mortgage-backed securities

SEC	US Securities and Exchange Commission
S&P	Standard & Poor's Ratings Services
Standard & Poor's	Standard & Poor's Ratings Services
USA	United States of America

Note to the Reader

We have devised a short form for a number of reports, regulatory papers, and rules that are frequently mentioned in the book. The glossary (see pp. 283–5) provides the full reference to these documents and therefore in the text they are just mentioned in their short form.

In those circumstances where an organization has been replaced by another one, we have opted for including in the text the latest name, except in those cases where this replacement could lead to confusion. This has been the case for CESR, that has been transformed into ESMA, CEBS to EBA, CEIOPS to EIOPA, and FSF to FSB. However, bibliographical references are kept using the name of the organization at the time the document was produced.

Finally, when referring to reports we have included a reference to the specific sections, paragraphs and/or pages that are relevant to the issue being discussed in the book. However, we have not done so in relation to those documents that will be changing in the near future as is the case, for example, with some of ESMA's guidance which, according to the amendment of the European Regulation on rating agencies, will have to be revisited shortly.

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Introduction

1.1 A HISTORY OF RATINGS AND THE ROLE OF RATING AGENCIES

1.1.1 Financial Markets Prior to Rating Agencies

Although nowadays credit rating agencies (CRAs) are a vital element of financial markets, this has not always been the case. In fact, as Professor Richard Sylla[1] accurately explains in his text *An Historical Primer on the Business of Credit Rating*, financial markets functioned well before rating agencies began operating in the USA at the beginning of the twentieth century.

At the start of the seventeenth century, the Dutch Republic, which was at the time the world leading economy, managed to have in place a modern financial system that included a banking system, an incipient central bank, and securities markets. Due to the influence of the Dutch, England also developed its financial market in the last decades of the seventeenth century and the USA, shortly after its independence at the end of the eighteenth century, had in place bond and stock markets in several cities.

Therefore, for several centuries financial markets functioned without CRAs. This was mostly due to the fact that investments during those early stages of securities trading mainly took place in public bonds (in most cases issued to finance wars) and investors trusted the governments as being able to repay their debts. Later on, when the international bond market grew during the nineteenth century in Europe, investment still continued to concentrate mostly on the sovereign debt market and most capital needs were covered by bank loans and share issues.

The situation in the USA was somewhat different, as its economy was of a larger scale than in other countries, but at the same time fragmented due to the federal organization. In the first decades of the nineteenth century, some US states first, and local governments after, issued debt to finance infrastructure projects. But soon the private sector incorporated these projects and an important corporate debt market developed.

The basic need for capital in the USA came in relation to the construction of railroads. Although there was initially some governmental support to create a

[1] Sylla, Richard (2002), *An Historical Primer on the Business of Credit Rating*. The New York University Salomon Center Series on Financial Markets and Institutions, Kluwer Academic Publishers.

railway network over the country, most US railroads raised capital as private corporations. At first, these corporations were able to finance themselves with bank loans and share issues as they were located in small regions of the country and local investors had knowledge of the projects. However, after 1850, the expansion of the activities of these companies to far away territories made it more complicated to gather local finance and thus they started issuing bonds. A huge corporate bond market was created, essentially from railroads bonds, that grew as fast as the railroad tracks themselves.

1.1.2 The Predecessors of Rating Agencies

Linked to the expansion of this corporate bond market and to the need of investors to gather information on increasing investment options, three institutions emerged as the predecessors of the credit rating industry.

1.1.2.1 Credit-reporting Agencies

The expanding American business, with transactions increasing in number, amount, and geographical scale, gave rise to a more sophisticated system for gathering information about borrowers. Until then, borrowers and lenders knew each other or had common contacts that could provide recommendation letters. But with the growth of the market, these informal channels became insufficient and a new institution, the credit-reporting agency,[2] appeared to fulfil the new markets need for professional information.

Credit-reporting agencies gathered information on the situation and creditworthiness of companies all over the USA and sold this information to subscribers. These agencies also offered related services, such as analysis of local economic conditions.

As creditors needed such information on companies that were dispersed all over the large territory of the USA, these credit-reporting agencies developed a network (branch) structure. This innovative structure linked local offices into an association trading under a common name. Correspondents sent their reports to local branches, which then forwarded them to the main office.

A well-documented example of the evolution of these agencies is the history of Dun & Bradstreet[3], which starts in 1841 with the creation of the Mercantile Agency as one of the first organizations formed with the sole purpose of providing business information. In 1870, the agency claimed to have 7,000 subscribers, and by the 1880s it estimated 40,000, including the largest companies in the country.[4] In 1962 Dun & Bradstreet acquired Moody's Investors Service, but in 2000 the company spun off its rating activity to create a separate CRA.

[2] Olegario, Rowena (2002), *Credit-reporting Agencies: Their Historical Roots, Current Status, and Role in Market Development*. Background document for the World Development Report 2002.

[3] Dun & Bradstreet, *History of Dun & Bradstreet*.

[4] Norris, James D. (1978), *R.G. Dun & Co., 1841–1900: The Development of Credit Reporting in the Nineteenth Century*. Westport, CT: Greenwood Press.

1.1.2.2 Specialized Publications

Together with these credit-reporting agencies, the appearance of a specialized business and financial press was also crucial to improve companies' information that was available for investors. As railroad corporations became the world's first big business, they soon required specialized publications, and by 1832 *The American Railroad Journal* provided thorough information about the industry. When Henry Varnum Poor became its editor in 1849, the journal turned into a publication aimed at investors, as it published systematic information on the ownership of railroads, their assets, liabilities, and earnings. In 1868, Poor[5] and his son published the first annual volume of *Poor's Manual of the Railroads of the United States*, which provided financial and operating statistics covering several years for most of the major American railroads. Through annual updates, the publication allowed investors to chart a company's progress over the years. This manual became the authoritative investors' guide to the state of railroad company finances for several decades and led the way to similar undertakings by others. By 1916 the Poor Company had entered into the bond rating business and in 1941 merged with the Standard Statistics Bureau, which had been publishing an annual volume since 1906 containing corporate news items that focused on industries beyond railroads.

John Moody & Company also started as a specialized publication with the release of *Moody's Manual of Industrial and Miscellaneous Securities* in 1900, the company's founding year.[6] The manual provided information and statistics on shares and bonds of financial institutions, government agencies, manufacturing, mining, utilities, and food companies. Later in 1909, Moody's company evolved into publishing more than a simple collection of information on the property, capitalization, and management of companies; it offered investors an analysis of security values. Moody's company published a book with an analysis and concise conclusion of the relative investment quality of the railroad companies and their outstanding securities. The conclusions were expressed using letter rating symbols adopted from the mercantile and credit rating system that had been used by the credit-reporting firms since the late 1800s. In 1909, *Moody's Analyses of Railroad Investments* described for readers the analytic principles that Moody used to assess a railroad's operations, management, and finance. In 1913, the manual was expanded to include the evaluation of industrial companies and utilities, besides railroads.

Another relevant specialized publisher, the Fitch Publishing Company,[7] was founded in 1913 by John Knowles Fitch. The company published financial statistics through publications such as the *Fitch Bond Book* and the *Fitch Stock and Bond Manual*. In 1924, the Fitch Publishing Company introduced the now familiar 'AAA' to 'D' ratings scale that was accompanied by an in-depth analysis of investment experts.

[5] S&P, *Standard and Poor's Company History*.
[6] Moody's, *Moody's History*.
[7] Fitch, *The History of Fitch Ratings*.

1.1.2.3 Investment Bankers

Investment bankers, the financial intermediaries who underwrote, subscribed, and distributed the securities from railroad companies, were also crucial to increasing the amount of information available about these companies. These bankers requested companies to provide all the relevant information in relation to their debt securities and the company itself. By participating in the operation, the banker's reputation was put at stake and, in this sense, the fact that a number of reputed bankers participated in the issuance was considered a certification of the quality of the bonds. This reputation capital, when some conflict-of-interest concerns were raised in relation to the bankers, was somehow transferred to CRAs in the sense that CRAs' participation provided a similar type of comfort to investors.

1.1.3 The Rise of Rating Agencies

CRAs, which evolved as a natural consequence of this need for specialized information based on the three institutions mentioned, were functioning under the 'subscription-paid' model; those investors needing the information would pay for it.

However, in the 1930s there was a change in the situation of CRAs[8] as bank regulators incorporated references in regulations to 'recognized rating manuals'. For the first time, in 1936, a decree prohibited banks from investing in speculative investment securities as determined by 'recognized rating manuals'. In the next decades, insurance regulators also started to include references to ratings and, in 1975, the US Securities and Exchange Commission (SEC) adopted the broker-dealer net capital rule that used the term 'NRSRO'[9] to classify debt instruments in terms of the amount they would be haircut for regulatory capital purposes, depending on the rating assigned by a NRSRO. Basically two kinds of regulatory requirements were incorporated: rules that restricted the extent to which a firm could hold assets that fell below investment grade and rules that linked capital requirements to the ratings on individual securities, with lower capital charges for high-rated securities.

These rules meant that the 'opinions' given by the CRAs became more and more relevant in financial markets as part of the regulation, and that private judgement on the risks of investments were being outsourced to the CRAs. At this point, CRAs were granted the ability to determine the substantive effect of legal rules.[10]

Among other reasons, this regulatory relevance led to a change in the business models of the CRAs that in the 1970s started charging issuers for the ratings. As CRAs realized that issuers needed their ratings to get their securities in the

[8] White, Lawrence J. (2010), Markets: The credit rating agencies. *Journal of Economic Perspectives*, 24 (2).

[9] The SEC then recognized Moody's, S&P, and Fitch as NRSROs.

[10] Partnoy, Frank (1999), The Siskel and Ebert of financial markets? Two thumbs down for the credit rating agencies. *Washington University Law Quarterly*, 77, October.