International Financial Law

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Introduction

The global financial crisis of 2007-2008 was a catastrophic event which has significantly affected the financial markets all over the world. It was basically triggered by the collapse of the housing bubble in the crisis led to the failure of major financial institutions, massive bailouts by governments, and a prolonged economic recession.[1] At the heart of this turmoil were Credit Rating Agencies (CRAs), based on which the creditworthiness of the issuers of debt securities was assessed. CRAs played an important role in the crisis by assigning high ratings to the risky mortgage-backed securities due to which the investors were misled and the financial stability was exacerbated.[2]

Credit rating agencies operate according to the issuer-pay model, where the entity issuing the securities pays the CRA for its rating services. Conflict of interest is created by this model as CRAs may be incentivized to provide favourable ratings to retain business from their clients.[3] The misaligned incentives contributed significantly to the financial crisis because overly optimistic ratings were issued by CRAs that did not reflect the actual risk of the securities.[4]

This paper aims to do a critical evaluation of the EU regulations of CRAs following the financial crisis, particularly focusing on the issuer-pay model. Specific regulatory measures will be examined such as shareholding limitation rules, mandatory contract rotation, and the double rating rule. These regulations were introduced to mitigate the conflicts of interest and improve the quality and reliability of the credit ratings. This research paper will discuss in detail the effectiveness of these measures to achieve their goals and maintain a balanced approach without overhauling the issuer-pay business model.

The Role of Credit Rating Agencies in the Financial Crisis

CRAs are rating entities in the financial market which are having the task of doing an assessment of the creditworthiness of issuers of debt securities. Ratings are assigned by them due to which the investment decisions, pricing of security and regulatory requirements for financial institutions are

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[1] Jones, Laurence, 'The Credit Rating Industry Under New Regulatory Regimes: The Case of Financial Institutions' (Bangor University (United Kingdom) 2019).
[2] Almutairi, Soud ARSM, 'The European Credit Rating Industry: The Impact of Regulations' (PhD diss., University of Portsmouth 2023).
[3] Moloney, Niamh. EU Securities and Financial Markets Regulation. Oxford University Press, 2023.
[4] Ibid.

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influenced. CRAs are operating under the issuer-pay model, where the entity issuing the securities pays the CRA for its rating services.[5] Economically this model is practical but it has introduced the inherent conflicts of interest. The incentive for CRAs to issue favourable ratings to secure repeat business from issuers has compromised their objectivity and the reliability of their ratings.[6]

The conflicts of interest of the issuer-pay model were evident during the financial crisis of 2007-2008. CRAs, including major players like Standard & Poor's, Moody's, and Fitch, issued overly optimistic ratings for mortgage-backed securities (MBS) and collateralized debt obligations (CDOs).[7] Due to these high ratings, the investors were misled about the true risk of these complex financial instruments therefore it contributed to excessive risk-taking and the eventual market collapse.[8] The EU recognized the detrimental role of CRAs and introduced the CRA Regulation (Regulation (EC) No 1060/2009) to deal with these conflicts and improve the integrity of credit ratings.[9]

Through the critical evaluation of the role of CRAs, it becomes clear that their biased ratings were not only due to the issuer-pay model but were also dependent on the lack of adequate regulatory oversight[10]. The aim of the CRA regulation is to mitigate these conflicts by improving transparency, mandating disclosures and imposing strict operational requirements on CRAs. However, the effectiveness of the regulation is under debate. It has introduced important reforms but it has not fundamentally altered the issuer-pay model due to which the questions are raised that the root causes of the problem are not sufficiently addressed.[11]

Moreover, the mandatory rotation of the rating analysts and the introduction of the double rating rule under the CR regulation had the intention to promote competition among CRAs.[12] Yet, the results of those measures were mixed. However, they reduced the direct conflicts of interest and also introduced complexes to maintain rating consistency and quality.[13] The shareholding

[5] Lawrence J White, "Credit-rating agencies and the financial crisis: Less regulation of CRAs is a better response" (2010) 25(4) Journal of international banking law 170.
[6] Ibid.
[7] Ibid.
[8] Maurice Mullard, "The credit rating agencies and their contribution to the financial crisis" (2012) 83(1) The Political Quarterly 77.
[9] Regulation (EC) No 1060/2009
[10] Ibid.
[11] Yilmaz Bayar, "Recent financial crises and regulations on the credit rating agencies" (2014) 5(1) Research in World Economy 49.
[12] Ibid.
[13] Siegfried Utzig, "The financial crisis and the regulation of credit rating agencies: A European banking perspective" (2010).

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limitation rules aimed to restrict undue influence from investors but at the same time faced criticism concerning the potential loopholes and enforcement challenges.[14] Therefore, the contribution of CRAs to the financial crisis has highlighted the need for a more robust regulatory framework based on which the economic realities of the issuer-pay model are balanced with the imperative of maintaining objective and reliable credit ratings.

EU Regulation of Credit Rating Agencies Post-Crisis

In the aftermath of the 2007-2008 financial crisis, the urgent need to reform the Credit Rating Agencies (CRAs) was recognized by the EU to restrict future market disruptions. The cornerstone of this regulatory overhaul was the CRA Regulation (Regulation (EC) No 1060/2009), which laid the foundation for a more transparent and accountable rating process.[15] Later on, this regulation was strengthened by the subsequent amendments and related directives to deal with the systemic issues faced during the crisis.

The major objective of the regulation was to minimise the conflicts of interest, increase transparency and improve the quality of credit ratings. One of the important measures introduced was the requirement for the CRAs to disclose their methodologies, models and key-rating assumptions promoting greater transparency and allowing the investors to make more informed decisions.[16] In addition, it was mandated by the Regulation (EC) No 1060/2009, Article 8(1) that CRAs register with the European Securities and Markets Authority (ESMA), which will oversee their activities and ensure compliance with the new standards.[17]

By critically evaluating these regulations the transparency requirements have made contributions to a more open rating process but challenges remain within it. The mandatory disclosure of methodology has improved investor understanding but also raised concerns regarding the potential for proprietary information to be misused by competitors.[18] Furthermore, while the oversight of

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[14] Timothy J Sinclair, "Credit rating agencies and the global financial crisis" (2010) 12(1) economic sociology_the european electronic newsletter 4.
[15] Ibid.
[16] Vassiliki L. Papaikonomou, "Credit rating agencies and global financial crisis: Need for a paradigm shift in financial market regulation," Studies in Economics and Finance 27, no. 2 (2010): 161-174.
[17] Ibid, art 8 (1).
[18] Katarzyna Sum, Post-Crisis Banking Regulation in the European Union (Palgrave Macmillan, 2016).

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ESMA has increased accountability, the effectiveness of this supervision has been questioned due to resource constraints and the complex nature of rating activities.[19]

The regulation also intended to reduce the conflicts of interest inherent in the issuer-pay model by introducing measures such as mandatory rotation of lead rating analysts and the double rating rule for which there is a need for certain financial instruments to be rated by at least two CRAs.[20] These measures are intended to prevent the long term relationship between CRAs and issuers from compromising rating objectivity.[21] However, the implementation of these rules has been met with mixed results. While they have curtailed some conflicts, they have also introduced operational challenges, such as maintaining consistency in ratings and ensuring that new analysts have sufficient expertise.[22] Furthermore, the shareholding limitation rules were introduced the prevent investors from exerting undue influence on CRAs by restricting ownership stakes. Although these rules aimed to further insulate CRAs from conflicts of interest, their effectiveness is limited by enforcement difficulties and potential circumvention through complex ownership structures.[23]

The Issuer-Pay Model and Regulatory Responses

The issuer-pay model is a dominant business structure for Credit Rating Agencies (CRAs), where issuers of securities pay CRAs to rate their financial instruments. This model is criticized because of its inherent conflicts of interest as CRAs may be incentivized to provide favourable ratings to retain business from issuers.[24] According to the critics it has compromised the objectivity and reliability of the ratings contributing remarkably to the 2007-2008 financial crisis. The response of the EU to regulatory measures sought to address these conflicts without completely overhauling the issuer-pay model, recognizing its economic practicality.[25]

One of the major regulatory responses was the introduction of the shareholding limitation rule under the CRA Regulation (Regulation (EC) No 1060/2009).[26] These rules were basically

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[19] Iris HY Chiu, "Regulating credit rating agencies in the EU: in search of a coherent regulatory regime," European Business Law Review 25, no. 2 (2014).
[20] Ibid.
[21] Ibid.
[22] Robert Wyse Jackson, "Europe's Supervisory System for Rating Agencies After the Financial Crisis: A Critical Review," Hibernian LJ 11 (2012): 1.
[23] Andreas Kruck, "Resilient blunderers: Credit rating fiascos and rating agencies' institutionalized status as private authorities," in Fiascos in Public Policy and Foreign Policy, 123-140 (Routledge, 2018).
[24] Ibid.
[25] Robert J. Rhee, "Incentivizing credit rating agencies under the issuer pay model through a mandatory compensation competition" (2014).
[26] Regulation (EC) No 1060/2009, art 6

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developed to restrict the investors from exerting undue influence on CRAs by restricting ownership stakes as mentioned Article 6a.[27] Specifically in Article 6a, they prohibited CRA shareholders with significant influence from owning more than 5% of another CRA, aiming to ensure independence and reduce conflicts of interest.[28] While these rules are having the aim to create a more level playing field, their effectiveness is questioned due to the enforcement challenges and the potential for circumvention through complex ownership structures and indirect shareholdings.[29] The intentions of the EU were commendable but the practical difficulties of monetary and enforcing this limitation highlight that more refinement is required.

Another important measure was the mandatory contract rotation rule which requires CRAs to rotate lead rating analysts regularly. This provision was intended to restrict the formation of overly cosy relationships between issuers and analysts due to which the objectivity of ratings could be compromised. According to Regulation (EU) No 462/2013, the European Parliament mandated that lead analysts be rotated every four years.[30] This measure has played a significant role in mitigating some conflicts of interest but at the same time, it has also introduced challenges such as ensuring continuity and expertise in ratings.[31] Due to the rotation of analysis, the rating process can be disrupted leading to inconsistency and lack of accuracy within the ratings. Moreover, frequent rotations might not be sufficient to eliminate deep-rooted conflicts, suggesting that complementary measures are necessary. The double rating rule, introduced as part of Regulation (EC) No 1060/2009 (Article 8c), mandates that certain complex financial instruments be rated by at least two different CRAs.[32] This requirement was established to promote competition and provide investors with the multiple responses minimising the risk-biased ratings.[33] Due to the double rating rule greater scrutiny is promoted and the reliability of the ratings is improved but it has also increased the cost for issuers who must pay for additional ratings. In addition, the effectiveness of the rule is dependent on the independent and diversity of the CRAs involved. If

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[27] Ibid, 6a
[28] Ibid, 6a
[29] Samuel B. Bonsall IV, "The impact of issuer-pay on corporate bond rating properties: Evidence from Moody's and S&P's initial adoptions," Journal of Accounting and Economics 57, no. 2-3 (2014): 89-109.
[30] Regulation (EU) No 462/2013
[31] Patrick S. Whalen, "The Issuer-Pays Model: 'Big Four' Auditors and Credit Rating Agencies Share a Common Conflict" (2016).
[32] Ibid, art 8(c)
[33] Günter Strobl and Han Xia, "The issuer-pays rating model and ratings inflation: Evidence from corporate credit ratings," Unpublished working paper (2012).

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both agencies are subject to similar conflicts of interest or methodologies, the intended benefits may not fully materialize.[34]

Shareholding Limitation Rules

The shareholding limitation rules under EU regulations were introduced to mitigate conflicts of interest within Credit Rating Agencies (CRAs) by restricting ownership stakes. As mentioned in the CRA Regulation (Regulation (EC) No 1060/2009), according to these rules significant shareholders are restricted from holding more than 5% of another CRA (Article 6a).[35] This measure if having the aim to ensure the independence of CRAs by restricting the investors or shareholders from creating undue influence on rating decisions thereby promoting a more transparent and unbiased rating process.

By doing the evaluation of the effectiveness of these rules it is evident that they have made a contribution to a reduction in direct conflicts of interest. By limiting cross-ownership, the regulations help to maintain a separation between CRAs and their clients, minimising their risk of biased ratings which are influenced by the major shareholders.[36] This structural separation is important to uphold the integrity of credit ratings and restore investor confidence in the financial markets. However, it is revealed through the critical analysis that there exist both the strengths and limitations of the shareholding limitation rule.[37] One of the major strength is their clear intention to safeguard the independence of CRAs which is important for objective credit rating assessment. Through ownership stakes, the rules directly address potential conflicts of interest that could arise from financial interdependencies.[38]

Despite the strengths, there are also significant weaknesses which can be discussed here. The complex nature of corporate structures and the potential for indirect ownership through subsidiaries or investment vehicles make it difficult to monitor and enforce compliance effectively.[39] In addition, other forms of influences are not addressed by these rules that large

[34] Han Xia, "The issuer-pay rating model and rating inflation: Evidence from corporate credit ratings" (PhD diss., The University of North Carolina at Chapel Hill, 2011).
[35] Ibid, art 6a
[36] McVea, Harry, 'Regulating credit rating agencies in the European Union: where might it lead?' (2010) 83 Amicus Curiae 2.
[37] Ndlovu, Tabani, 'Credit rating agencies: regulatory changes and market participants' perspectives' (PhD diss., Oxford Brookes University 2013).
[38] Ibid.
[39] Parker, Edmund and Bake, Miles, 'Regulation of credit rating agencies in Europe' (2009) Butterworths Journal of International Banking and Financial Law 401-403.

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investors might wield, such as advisory roles or contractual agreements. This oversight means that while direct shareholding limits are imposed, indirect forms of influence remain a concern.[40]

Mandatory Contract Rotation

The mandatory contract rotation rule is another important measure introduced under EU regulations to address conflicts of interest within CRAs. According to Regulation (EU) No 462/2013, there is a need to rotate the lead rating and analyst of CRAs after every 4 years.[41] The main purpose of this rotation is to restrict the development of overly familiar relationships between issuers and analysts which could compromise the objectivity and reliability of credit ratings.

By the critical evaluation of the effectiveness of the mandatory contract rotation rule it is determined that it has contributed to reducing the conflicts of interest and restricting the complacency among rating analysts.[42] By regularly rotating analysts, the long-term relationships that will lead to biased ratings are disrupted by this rule. It is ensured by this fresh perspective that ratings are based on up-to-date and independent assessments leading to improve the credibility of CRAs. In addition, there are also certain weaknesses of the rotation rule. One of the major challenges is to maintain the consistency and expertise in the rating process.[43] The continuity of ratings can be disrupted by the frequent rotations, as new analysts may not have the same level of familiarity with the rated entities. This may lead to discrepancies and potentially lower the quality of the ratings. Moreover, the rigid structure of the rule does not account for the varying complexities of different financial instruments, where longer-term analysis may be beneficial.[44]

Double Rating Rule

The double rating rule, introduced under Regulation (EU) No 462/2013 (Article 8c), asserts that certain complex financial instruments be rated by at least two different Credit Rating Agencies (CRAs).[45] The major objective of this rule is to increase the quality of ratings and promote competition within the credit rating industry.[46] Requirement of multiple ratings is established by

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[40] Ibid.
[41] Ibid.
[42] Michael C. Nwogugu, "Structural Changes, Competition And Complexity: Credit Rating Agencies (CRAs) And Allocation Mechanisms For Accounting Firms" (2011).
[43] Ibid.
[44] Andrea Miglionico, "BUSINESS MODEL OF CRAs," in The Governance of Credit Rating Agencies, (Edward Elgar Publishing, 2019), pp. 35-93.
[45] Ibid, art 8(8c)
[46] Ibid.

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the regulation to provide investors with the more comprehensive and reliable information so that the risks can be mitigated that a linked to the biased and inaccurate ratings from a single CRA.[47]

It is determined through the evaluation of the effectiveness of double the rating rule it has proved successful to improve the rating quality and increasing competition. [48] The rule has encouraged CRAs to endeavour for higher standards and accuracy in their ratings, knowing that their assessments will be compared against those of their competitors. In addition, the requirement for multiple ratings has led to increased scrutiny and reduced the likelihood of conflicts of interest influencing the ratings.[49] However the rule has also certain limitations. One of the major weakness is the increased cost for issuers, who must now pay for additional ratings, due to which they are discouraged from getting multiple ratings. However, the double rating rule is effective and efficient, but depends on the independence and diversification of the CRAs that are engaged. Even when the overall purpose of two agencies may be clear, if they face the same problems of conflict of interest or of methodology, the actual benefits might not be materialized.[50]

Impact on Competition, Industry Diversity, and Rating Quality

The anti-competitive laws such as the shareholding limit rules for CRAs as well as the provisions for mandatory contract rotation together with the double rating rules are essential and exert tremendous influences on competition between CRAs. These regulations have promoted a more comparative environment by minimising the conflicts of interest and increasing transparency.[51] Due to the maximum competition within this particular market, the introduction of new players is encouraged and hence industry diversification. It has also proposed that rating quality has become better after the regulation due to the changes in code of ethics of the CRAs accompanied by stricter oversight and higher standards.[52]

Conclusion

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[47] Gudula Deipenbrock, "Trying or Failing Better Next Time?-The European Legal Framework for Credit Rating Agencies after Its Second Reform," European Business Law Review 25, no. 2 (2014).
[48] Ibid.
[49] Jan De Bruyne and Cedric Vanleehove, "Rating the EU Regulatory Framework on the Liability of Credit Rating Agencies-Triple A or Junk," Edinburgh Student L. Rev. 2 (2013): 117.
[50] Nina Dietz Legind and Camilla Horby Jensen, "The European regulation of credit rating agencies," Law Context: A Socio-Legal J. 30 (2014): 114.
[51] Ibid.
[52] Ibid.

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To sum up, the regulatory approach of the EU to Credit Rating Agencies post-financial crisis has led to remarkable measures for the purpose of reducing conflicts of interest and improve rating quality. The shareholding limitation rules, mandatory contract rotation, and double rating rules have increased transparency, competition and industry diversity. However, there also exist challenges along with these measures such as enforcement difficulties and the inherent limitations of the issuer-pay model. Therefore, the regulatory framework has created a balance between addressing the conflicts of interest and maintaining the issuer-pay model, but there is a need of continuous refinement and vigilant oversight. The focus of future regulatory improvements should be on improving the enforcement mechanisms and mitigating the indirect conflicts of interest by ensuring the continued integrity and reliability of credit ratings.

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