

Band 102

Schweizer Schriften zum Finanzmarktrecht

Herausgegeben von

Prof. Dr. Dieter Zobl

Prof. Dr. Mario Giovanoli

Prof. Dr. Rolf H. Weber

Dr. iur. Aline Darbellay

Regulating Ratings

The Credit Rating Agency Oligopoly
from a Regulatory Perspective

Schulthess § 2011

Table of Contents

Acknowledgements	V
Summary of Contents	VII
Table of Contents	IX
Abbreviations	XVII
Bibliography	XIX
PART 1: Prelude to the Credit Rating Industry	1
§ 1. Introduction	1
I. Background	1
II. Evolving Role of Credit Rating Agencies in Modern Financial Markets	4
III. Research Scope and Perspectives	7
IV. Outline	9
§ 2. History of Credit Rating Agencies	10
I. Before 1907: From Informal Sources of Information to Mercantile Agencies	11
1. Dominance of Informal Channels and Increasing Need for Credit Information	11
2. Creation of Mercantile Agencies	12
II. 1909-1930s: Origins of the Credit Rating Industry	14
1. Emergence of the First Credit Rating Agencies	14
2. Attitude of Investors to Credit Ratings	14
3. Building Reputational Capital	16
III. 1930s-1970s: Decreasing Interest in the Credit Rating Agencies	17
1. First Uses of Credit Ratings in Regulation	17
2. Doubts over Credit Rating Accuracy and Decline of Investor Confidence	18
IV. Since 1970s: Enhanced Profitability of the Credit Rating Business	19
1. Expanding Use of Credit Ratings in Regulation	19
2. Shift from Subscribers' Fees to Issuers' Fees	20
3. Rating Novel Financial Instruments	21
V. Analyzing the Evolution of the Credit Rating Industry	22

§ 3.	Description of the Credit Rating Industry	24
I.	Core Activities of the Credit Rating Agencies	24
1.	Providing Investors with External Credit Ratings	25
a.	Definition of a Credit Rating	25
b.	Financial Information Embedded in Credit Ratings....	26
2.	Counseling Issuers in Doing Ancillary Business	28
II.	Rating Process	29
1.	Providing Initial Credit Ratings	29
2.	Reviewing Credit Ratings	31
III.	Main Uses of Credit Ratings in Modern Financial Markets	32
1.	Credit Ratings as Providing Financial Information	33
2.	Credit Ratings as Regulatory Tools	34
3.	Credit Ratings as Contracting Tools	35
4.	Credit Ratings as Monitoring Tools	36
 PART 2: Competitive Environment in the Credit Rating Industry ...		39
§ 4.	Regulatory Structure and Effects on Competition.....	39
I.	Background.....	39
1.	Three Regulatory Aspects Influencing the Competitive Environment in the Credit Rating Industry.....	39
2.	US Dodd-Frank Act of 2010	40
II.	Rating-Based Regulations	41
1.	Use of Credit Ratings for Regulatory Purposes and Negative Effects on Competition.....	41
2.	Regulations Depending on Certified Credit Ratings	43
a.	Bank Capital Requirement Regulations	44
b.	Regulatory Investment Restrictions.....	45
3.	Distortions of Competition with respect to Rating- Based Regulations.....	47
a.	Regulatory Barrier to Entering the Credit Rating Industry	47
b.	Market Over-Reliance on Credit Ratings	49
c.	Rating-Driven Market Behavior	52
4.	Withdrawal of Rating-Based Regulations.....	54
a.	Trend to Reduce Regulatory Dependence on Credit Ratings	54
b.	US Dodd-Frank Act of 2010.....	55
III.	Regulatory Oversight of Credit Rating Agencies.....	56
1.	Regulation and Competition	56

2.	From Self-Regulation to the Creation of Regulatory Frameworks for Credit Rating Agencies	57
a.	Self-Regulation in the Credit Rating Industry	57
b.	Merits and Weaknesses of Self-Regulation	58
c.	Toward the Regulation and Supervision of Credit Rating Agencies	59
3.	Strengthening Credit Rating Agency Oversight	60
a.	US Model for Agency Regulation and Supervision	60
b.	EU Model for Agency Regulation and Supervision	63
IV.	Special Treatment for Credit Rating Agencies	67
1.	Privileged Treatment and Effects on the Competition	67
2.	Historically Privileged Position of Credit Rating Agencies in the US	68
a.	US Liability Regime for Credit Rating Agencies	68
b.	SEC Regulation FD Exemption for Credit Rating Agencies	69
3.	US Dodd-Frank Act of 2010	70
4.	EU and Swiss Liability Regime for Credit Rating Agencies	72
V.	Regulatory Trends and Competitive Aspects	76
§ 5.	Road Ahead for a Competitive Credit Rating Market	80
I.	Background	80
1.	Credit Rating Agencies' Incentives in the Run-Up to the Subprime Mortgage Crisis	80
2.	Competition and Leading Credit Rating Agencies	82
3.	General Competition Law and Sector-Specific Regulation	84
II.	Concerns about the Level of Competition in the Credit Rating Industry	86
1.	Concept of Competition with Respect to Credit Rating Agencies	86
2.	Distortions of Competition among Leading Credit Rating Agencies	89
a.	Oligopolistic Market Structure	89
b.	Deformation of Incentives in the Credit Rating Industry	92
III.	Creation of a Competitive Market for Financial Information	93
1.	Information Intermediaries and Competitive Incentives	93

2. Information Asymmetries and the Cost of Financial Information.....	95
§ 6. Preliminary Conclusion	96
PART 3: Uses and Abuses of Credit Ratings in Structured Finance.....	99
§ 7. Background.....	99
I. Credit Ratings and Structured Finance.....	99
II. Financial Market Context.....	101
1. From a Bank-Based to a Market-Based Financial System.....	101
2. Expansion of Credit Risk Transfer Instruments.....	103
3. Increasing Leverage of Financial Institutions.....	104
III. Subprime Mortgage Crisis	105
IV. Financial Instruments at the Heart of the Subprime Mortgage Crisis	109
§ 8. Growth of the Structured Finance Segment.....	115
I. Regulatory Incentives.....	115
II. Crucial Role Played by Credit Rating Agencies in the Expansion of Structured Finance	116
1. Credit Rating Agencies' Key Position in Structured Finance	116
2. Credit Ratings as a Marketing Tool for Securitized Assets	118
3. Proliferation of Rating-Driven Transactions.....	119
III. Regulatory Arbitrage and Rating Arbitrage	120
§ 9. Wrong Incentives in the Credit Rating Industry.....	123
I. Conflicts of Interest in the Credit Rating Industry.....	123
1. Issuer-Pays Business Model.....	123
2. Ancillary Services	125
3. Interferences Between Credit Rating Agencies and Issuers.....	126
II. Absence of Reputational Constraints in Rating Structured Products	128
III. Over-Reliance on Quantitative Models.....	130
1. Failure to Adapt Rating Models to New Market Trends..	130
2. Flaws in the Rating Models	132
3. Dependence on Rating Models for Valuation Purposes...	134

IV.	Market Over-Reliance on Credit Ratings in Structured Finance	135
V.	Exploitation of Information Asymmetry in the Market for Securitized Assets.....	138
§ 10.	Preliminary Conclusion	143
PART 4: System-Wide Effects of Credit Rating Downgrades		145
§ 11.	Background.....	145
I.	Systemic Importance of Credit Ratings in Modern Financial Markets.....	145
II.	Financial Stability and Systemic Risk.....	149
§ 12.	System-Relevance of Credit Ratings	153
I.	Credit Rating Oligopoly	154
1.	High Concentration in the Credit Rating Industry.....	154
2.	Barriers to Entering the Credit Rating Industry.....	155
3.	Collective Market Power of the Leading Credit Rating Agencies.....	157
II.	Market Over-Dependence on the Leading Credit Rating Agencies	158
1.	Regulatory Reliance on Credit Ratings.....	158
a.	Rating-Based Regulations	158
b.	Collateral Policy of Central Banks	161
2.	Behavioral Reliance on Credit Ratings.....	162
a.	“Rating Triggers” in Contracting.....	163
b.	Rating-Dependent “Collateral Triggers” in Contracting	164
§ 13.	Homogenous Market Reactions to Credit Rating Downgrades	166
I.	Homogenization of Information in the Financial Markets.....	167
1.	Amount of Available Information and Selection of Relevant Information	167
2.	Credit Ratings of the Leading Credit Rating Agencies as a Homogenizing Factor	168
II.	Signaling Effects of Credit Rating Downgrades	170
III.	Homogenization of Market Behavior.....	171
§ 14.	Consequences.....	173
I.	Procyclicality	173
II.	Spillover Effects of Credit Rating Downgrades by the Leading Credit Rating Agencies	176

III. Leading Credit Rating Agencies' Reluctance to Downgrade	178
1. Rating Stability	179
2. "Too Big to Downgrade"	181
3. "Too Big to Be Downgraded"	182
§ 15. Preliminary Conclusion	183
PART 5: Trends and Outlook	185
§ 16. Restoring Competition in the Credit Rating Industry	185
I. General Approach	185
II. Moving Away from Market Over-Reliance on Credit Ratings	188
1. Incentivizing Investors' Own Due Diligence	189
2. Appropriate Disclosure Requirements of Financial Information	190
3. Finding Substitutes for Credit Ratings	194
4. Reducing the Systemic Importance of Credit Ratings	195
III. Theoretical Approach to Competition in the Credit Rating Industry	197
1. Antitrust Laws as a Response to Market Failure	198
2. Revisited Incentive-Based Financial Market Regulations as a Response to Regulatory Failure	200
§ 17. Proposal for a New Revenue Model in the Credit Rating Industry	203
I. Description	203
1. Context and Objectives	203
2. Characteristics	204
a. Shifting from Issuer-Pays to Investor-Pays Business Model	205
b. Increasing Credit Rating Agencies' Accountability	207
II. Creation of Appropriate Incentives	209
1. Lessening Issuers' Interest in Paying for Credit Ratings	210
2. Increasing Credit Rating Agencies' Interest in Marketing their Credit Ratings to Investors	211
3. Incentivizing Investors to Hire Credit Rating Agencies and Perform their Own Due Diligence	212
III. Implementation	213
1. Legal Framework	214
2. Contractual Terms	215

IV. Screening the Possible Consequences of the Model	216
1. Is There a Risk of Artificially Deflated or Inflated Credit Ratings?.....	216
2. Would the Price for Credit Ratings Be Extremely Low?	217
3. Would Investors Pay Poorly Performing Credit Rating Agencies?	218
§ 18. Concluding Remarks	218