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Does the regulation adopted in the US and EU in the aftermath of the financial crisis for Credit Rating Agencies (CRAs) resolve the Conflict of Interest (CI) the 'issuer-pays’ business model of CRAs creates between issuers and raters?*

Francisco Endara Flores†

*“Everything was investment grade. It didn’t really matter”(Voorhees, R., 2011, p. 875).

“There was not in the short term economic self-interest of either... to provide accurate credit ratings (...) because doing so would have hurt their own revenues.”(Report by the Senate Permanent Subcommittee on Investigations, 2011, Bernal, Girard & Gnabo, 2016, p.48)

Abstract: The present essay analyses, if the regulation adopted in the European Union (EU) and the United States (US) in the aftermath of the financial crisis of 2008 resolves the CI the 'issuer-pays’ business model of CRAs creates between issuers and raters. It will be argued in the present paper that the shortcomings of CRAs prior to the 2008 financial crisis were not only the result of rating errors and poor operating practices, but the culprit also lies in the business model CRAs have which is prone to inflated ratings or rating shopping.

This article argues that regulations should extend the Cuomo Agreement to all ratings, which applies only to ratings of residential mortgage debt securities in New York until a better alternative is proven superior. The Cuomo Agreement would act as an ex ante control improving rating accuracy since CRAs are paid upfront before issuing the rating and are required to disclose all ratings to reduce rating shopping.

Keywords: conflict of interest, credit rating agencies, issuer-pays business model.

* The views and opinions expressed in this article are of the author alone and do not reflect the opinion, position of the author’s employer.

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I. INTRODUCTION

During the 2008-2009 financial crisis, as had happened with the ENRON case in 2001, CRAs failed to recognize the financial condition of the rated institutions; in the case of Lehman Brothers it maintained “investment grade” until the day bankruptcy was declared in 2008 (White, 2010, p. 218). As a result, CRAs were once again (White, 2010, p. 218) in the eye of the storm and were severely criticized by scholars, commentators, politicians and the public for what many, perceived as errors in their ratings and poor operating practices (Rhee, 2015, p. 161). Consequently, their activities came under the scrutiny of regulators to overhaul their practices.

In the US, the Dodd-Frank Act (DFA) was passed in the aftermath of the crisis and includes a section for CRAs (Rhee, 2015, pp. 161-162). The EU followed a similar approach, and for the first time, in 2009 it approved compulsory regulation of CRAs. However, as it will be argued in the present paper the shortcomings were not only the result of rating errors and poor operating practices. The culprit lies in the business model that CRAs have, the so-called issuer-pays business model, under which the issuer of the rated instrument pays the CRAs for the rating, which results in a conflict of interest between the issuer and the agency doing the rating of the instrument.

Accordingly, the regulatory response has centered on managing the CI from a corporate governance perspective by incorporating mechanisms designed to avoid corruption in the decision-making process of CRAs with more internal oversight and external accountability of CRAs.

The present paper will review the regulations passed by the EU and the US in the aftermath of the financial crisis to determine if they correctly tackle the Conflicts of Interest (CI) attributed to CRAs business model or not. For that purpose, the review will focus exclusively on the remedies to correct the CI of the issuer-pays business model; other solutions for alleged shortcomings of CRAs are not discussed as they are beyond the purpose of this paper.

This article argues that regulations should extend to all ratings since the Cuomo Agreement which only applies to ratings of residential mortgage debt securities in New York until a better alternative is proven superior. The Cuomo Agreement would act as an ex-ante control improving ratings accuracy since CRAs are paid upfront before issuing the rating and are required to disclose all ratings perform reducing rating shopping.

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3 In the US Congressional Committees this issue was heavily debated.
II. What are CRAs and THEIR role

Before analyzing the CI that the current business model of CRAs possess it is crucial to understand what CRAs are and the role they play in the market. CRAs can be defined as financial entities that measure "the risk that an entity or transaction will fail to meet its financial commitments, such as interest payments and repayment of principal, on a timely basis" (MacNeil & Satragno, 2014, p. 178).

CRA ratings have some key features necessary for our analysis. The first one is that ratings classify securities or financial instruments as investment grade, non-investment grade or speculative debt by assigning them a grade (Macneil & Satragno, 2014, p. 179). The ratings can be solicited or unsolicited; the difference is that in the first one the issuer of the security requests and pays the CRAs to rate the security. In an unsolicited rating, CRAs conduct their own independent assessment (Macneil & Satragno, 2014, p. 179). Unsolicited ratings rely on publicly available information; whereas solicited ones used public and private information provided by the issuer to the CRA (Macneil & Satragno, 2014, p. 180).

This paper focuses on solicited ratings as they are considered to produce the CI associated with the CRAs, business model. Unsolicited ratings are generally deemed to have "positive effects for markets and investors: (a) because unsolicited raters can conduct their own analyses independently of the CRAs contracted by the issuers and/or originators. They may counter the rating opinions of solicited CRAs; thereby, increasing the amount of available information to the market and offsetting rating shopping. (b) They help potential new entrants increase their market coverage and build their rating reputation, thereby fostering competition." (Staikouras, 2012, p. 88). Having said that, some commentators think unsolicited ratings can be used by CRAs to force issuers into working with them by issuing a low rating (i.e., low which does not adequately reflect the creditworthiness of an issuer) or the CRA can use it as a tool to increase market share (Wittenberg, 2015, pp. 679-680).

CRAs have a dual role in the market: (i) help solve the information asymmetry that exists in the market between lenders and borrowers since the borrower knows more about its creditworthiness than the creditor, who does not know if the borrower would be able to repay its loan or not (White, 2010, p. 212). Hence, CRAs by providing an analysis of the payment capacity of the borrower are supposed to eliminate or reduce this asymmetry acting "as an information intermediary that produces independent information on the borrower's creditworthiness. Rating agencies provide new information or verify information."

\[\text{Nevertheless, as discussed later, competition for CRAs creates additional problems.}\]
(Rhee, 2015, p. 163). (ii) The second function is that they help reduce the cost of regulation (Rhee, 2015, p. 163), by freeing investors and regulators\(^5\) from developing or duplicating the infrastructure and analytic expertise required to analyze bond investments (Rhee, 2015, p. 164). An example of the regulatory function of CRA is the reference by Regulators to CRA ratings to determine the capital banks are required to have or the type of assets they could have, usually “investment grade” bonds or securities.\(^6\) Investors also relied on ratings in contracts as a tool for measuring and limiting risk (Becker & Milbourn, 2011, p. 93). Other scholars think that CRAs have a third function, CRAs operate “contractual limitations on the investment powers of fund managers as well as a potential guide for courts to the fiduciary duties owed by fund managers to their clients.” (MacNeil & Satragno, 2014, p. 181).

Scholars like Rhee (2015) consider the previous explanations insufficient. CRAs are better seen as information disseminators that compile, organize information that helps market actors sort information in a systematized categorization of the vast spectrum of the credit market (p. 170). They do so in “a way that no other market actor or groups of market actors can replicate this function, and this function contributes to the efficiency of the credit market” (Rhee, 2015, p. 170).

Other scholars consider that CRAs have a public function as gatekeepers of financial markets that are beyond the mere transactional level (Rhee, 2015, p. 172). The gatekeeping relationship is given when the debt issuer hires a CRA (a client engages an agent to act in the best interest of a third party) to assess their creditworthiness and the security of the debt to investors considering lending to the borrower (Duff & Einig, 2014, p. 554). Under this relationship CRAs have a role like auditors (i.e. independent third parties), which since the Sarbanes–Oxley Act must act independently of the issuer of the transaction, in a role that differs to the one of a lawyer who usually acts as an agent of the issuer or the party that has hired him in the transaction, and they should be regulated along those lines. Under this view, CRAs act as “reputational intermediaries,” (…) providing quality assurance for investors who (…) cannot practically assess the risk of their investments on their own.” (Guo, 2016, p. 188).

Depending on the role that one assigns to CRAs the regulatory responses to their conduct differ. For example, if one subscribes to the view that they have a

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\(^5\) Regulators give CRAs the “NRSRO status (‘Nationally Recognized Statistical Rating Organization’), which is a license to regulate domains of investments by and capital structures of financial institutions” (Rhee, 2015, p. 164).

\(^6\) In the US, this remotes to 1930 when Bank Regulators started requiring banks to invest only in safe bonds determine according "recognized rating manuals," and later it became an explicit reference to a letter rating "AAA." For more see White, 2010, p. 213.
regulatory role as the one mentioned above, CRAs role should be limited or eliminated. If one considers CRAs have a market function the policy should seek to improve their performance and functioning (Rhee, 2015, p. 172). As later discussed, CRA regulation has tried to tackle both aspects, reducing the regulatory use of ratings and lessen the CI to improve their functioning.

III. BUSINESS MODEL AND CI
At the heart of the CI debate of CRAs is their business model, the so-called issuer-pays model. Under this model, the entity issuing the bonds/security pays the CRA for the rating. As opposed to the business model that prevailed from 1909 to 1970 where CRAs would sell the ratings to the investors via subscription, this model is known as the investor-pays model.

The reason for switching the business model was attributed to a free-rider problem. It was feared that technology (e.g., photocopying, fax machines) would help investors obtain free copies of the ratings from other investors which would "free ride" without subscribing to the service (White, 2010, p. 214).

Another explanation is that after Penn-Central Railroad bankrupted in 1970, debt issuers wanted to pay CRAs that would assign them an excellent rating (White, 2010, p. 214), along those lines is the explanation that the debt issuer needed to have more than one rating and they would have to pay for this service (White, 2010, p. 214).

One thing that it is uncontroversial is that the current business model attaches potential CI: “A rating agency might shade its rating upward to keep the issuer happy and forestall the issuer’s taking its rating business to a different rating agency.” (White, 2010, p. 215). Moreover, the “relationship is fraught with major CI because the interests of issuers on their ratings often do not align with the needs of investors to receive reliable ratings information” (White, 2010, p. 215).

White (2010) points out that the CRAs concern for their reputation seemed to have kept the CI at bay for the first three decades (p. 215). The reason

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7 In this case, the market function of CRAs is “the creation and maintenance of a system of information sorting. This sorting, then, facilitates market efficiency” (Rhee, 2015, p. 173).
8 In the present paper the term bond, security, finance instruments are used as synonyms, unless otherwise stated.
9 For a detailed analysis of the history and evolution of the CRAs business models see White, 2010, p. 213.
10 See also Macneil & Satragno, 2014, 182.
11 Regulators stressed that the concentrated nature of the Credit Rating Agency Industry dominated by the “big three” Moody’s, Standard & Poor’s and Fitch, prevents the reputation
would seem to be the type of instrument that was rated. In this case, bonds (corporate and government) because of the massive volume of issuers the threat to take their business elsewhere was not sufficient.

The second reason was the nature of the bond itself that was not complex enough to "cover up" inflated, higher or incorrect rating as it would have been spotted too quickly and would have tarnished the CRA reputation (White, 2010, p. 215). Ponce (2012) finds supporting evidence of this by concluding that "when rating complex products becomes a major source of income for the rating agency, it is always too lax." (p. 296).12

All the arguments above fall under the umbrella of the so-called "reputation defense" which was used quite successfully by CRAs to resist or weaken attempts to regulate them. The reputation defense was predicated on the notion that credibility is the most valuable asset of CRAs (Staikouras, 2012, p. 79). Therefore, the fear of losing reputational capital constitutes the most efficient control mechanism for CRAs behavior (Staikouras, 2012, p. 79).

In the case of CRAs, the reputation defense was not a behavior constraint because they were able to inflate rating by the presence of naïve investors (Staikouras, 2012, p. 80). The boom years prior to the 2008-2009 financial crisis allowed them to: "overstated ratings because (a) CRAs find it more difficult to maintain high-quality personnel, (b) investors are less incited to perform due diligence, and (c) default probabilities are lower, CRAs’ monitoring is lax, and as a result, their reputation risk for getting caught is lower." (Staikouras, 2012, p. 80).

All this dramatically changed in 2008-2009 when the subprime bubble burst, shattering the illusion that CRAs could keep at bay the CI associated with the issuer-pays model. Mainly because CRAs no longer rated corporate and governmental bonds, they were rating mortgage-related or backed securities much more complex instruments that bonds "so rating errors were less likely to be quickly spotted by critics (or arbitragers)" (White, 2010, p. 221).

There are several factors for this "ratings [for complex instruments] are (...) more difficult for outsiders to monitor; CRAs may be reluctant to employ more resources to support such ratings, or the combination of lucrative revenues from rating novel products." (Staikouras, 2012, p. 81). Moreover, to grade the mortgage-related securities, they became heavily involved with the issuer of those instruments, consult extensively with them before assigning a rating (White, 2010, p. 221).

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12 See also Mullard, M., 2012, p. 81.
Another difference was the number of players involved, unlike corporate bonds, the issue of mortgage-backed securities was confined to a small number of investment banks (White, 2010, p. 221) that can take their business elsewhere if unhappy with the rating allowing them to exploit that leverage (Strier, 2008, p. 537), making CRAs susceptible to the pressure to assign a higher rating. During the pre-crisis years, CRAs were needed to secure the business from big investment banks since the revenues from rating this structured finance products became the main source of revenue. For example, Moody’s in 2007 saw a growth of 86% in the fourth quarter earnings mainly driven by these new products (Strier, F., 2008, p. 536). Therefore, the two barriers that kept the CI at bay were gone.

As former Moody’s and S&P employees testifying before the US Senate Committee said: "gaining market share, increasing revenues, and pleasing investment bankers (…) assumed a higher priority than issuing accurate credit ratings" (Voorhees, 2011, p. 879). Internal e-mails corroborate the testimonies and show CRAs willingness to adjust the ratings to keep/increase market share (Voorhees, 2011, p. 879). On top of that investment banks started to hire CRAs employees that knew the ins and outs to secure the highest rating (Voorhees, 2011, p. 879) from the CRA, entrenching further the CI.  

The disincentive to downgrade an original rating emerges not only because the issuer could retaliate by going to other CRA, but it is also a threat to the CRA reputation, because if the CRA realizes that the initial rating was "inflated," then it had to choose between downgrading or not. "If it does nothing and the bonds do not default, everyone is happy, and there are no adverse consequences (…). If the bonds do default, then, of course, the rating agency will be censured. Conversely, if (…) downgrades and the downgraded bonds do not default, the rating agency risks the ire of, and possible future loss of business with, the issuer" (Strier, F., 2008, p. 538).

Empirical evidence supports that notion. For example, Moody’s experienced exponential growth (2003-2006) and gains until 2007 when it was harder for investment banks to get a higher rating.; that year there was a drop market share (from 75% to 25%) (Strier, 2008, p. 536) of the structured financial products. Additional studies conducted by Patrick Bolton, Xavier Freixas, and Joel Shapiro (2012), show evidence that rating inflation occurs in boom times where there is "larger clientele of investors in the market who take ratings at face value, and when the risks of failure which could damage CRA reputation are lower." (Bolton, Freixas, & Shapiro, 2012, p. 86).

Further studies corroborate that issuer-pays model leads to higher ratings. A study analyzing ratings between 1971 and 1974 when Moody's adopted the

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13 For a more detailed description on this topic see Voorhees, 2011, p. 879.
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The adoption of the issuer-pays business model produced three CI. Revenue became contingent on the fee issuers pay the CRA (Strier, 2008, p. 537). As Miglionico (2014) points out, an incentive was created to “over-rate to secure a high fee and inflated ratings” (Miglionico, A., 2014, p. 201). “Issuers desire high ratings and not necessarily accurate ones” (Miglionico, A., p. 201). because the higher the rating the least concern investors are likely to be about the possibility of default by the issuers, and the cost of capital for the issuer is lower. (Miglionico, A., p. 201).

The problem is aggravated by the presence of trusting investors (i.e., pension funds managers or managers that because of a regulatory requirement must purchase the highest rated products) that rely exclusively on the ratings without doing their own assessment of default risk, taking them at face value.

If you combine to that CRAs reliance on fees from issuers, "and issuers looking to benefit from the mispricing of their issues could have led to substantial rating inflation with important systemic consequences" (Bolton, Freixas, & Shapiro, 2012, p. 86) as arguably was the case during the 2008-2009 financial crisis.

The other two CI emanate from the first CI and prevent CRAs from acting independently from the issuers who hired them (Strier, 2008, p. 537). The second conflict appears in the consulting arrangements or ancillary services the CRA started to provide to issuers, that the financial crisis of 2008 brought to light as rating agencies had been not only rating the financial instruments but had been
designing the products that they would later be required to rate. (Strier, 2008, p. 537)

The third conflict is the incentive to "inflate" or “give high ratings”—and the corresponding disincentive to downgrade original ratings—(Strier, 2008, p. 537) to guarantee that the Issuer is happy and does not change provider. Likewise, issuers can engage in “rating shopping” by purchasing and publishing the more favorable rating’(Bolton, Freixas, & Shapiro, 2012, p.86). In other words, issuers can cherry-pick which ratings they present to the market (Staikouras, 2012, p. 88).

An alternative view classifies CI from the perspective of the CRA themselves and the perspective of the credit analyst (Lin, 2010, p. 260).

1. From the analyst perspective
The first conflict is that they could own the securities or bonds they must rate (García Alcubilla & Ruiz del Pozo, 2012, p. 4). Here the fear is that analyst might influence the rating process by owning the product being rated (Lin, 2010, p. 260).

Another one is when CRA employees act as directors of the rated entity. "For example, Clifford L. Alexander, Jr., former chairman of Moody's, served on the board of WorldCom IMCI for nineteen years. During this period, WorldCom IMCI received favorable ratings even after the market- implied rating from credit spreads had fallen below investment grade." (Lin, 2010, p. 260).

A CI can appear when issuers hand out gifts, favors to the credit analyst hoping to influence in the rating process (Lin, 2010, p. 261). On top that, a CI can be created when the CRA packs together analyst compensation based on the fees they the amount they generate from the issuers. If their payment is contingent on the rating they are tempted to give a higher rate, so they could keep or increase the business for the CRA (Lin, 2010, p. 261).14

2. From the CRA perspective
This CI appears at the beginning of this section and originates from the ancillary services the CRA provides to issuers or the CI that can occur when the CRA is affiliated with the entity the broker or dealer of the financial instrument been rated(Lin, 2010, p. 261). Ancillary services can also be used by the CRA to pressure the issuer to buy those additional services for fear of triggering a retaliation in an unfordable rating, or they buy them hoping to get a better rating (Lin, 2010, p. 262).

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14See also García Alcubilla & Ruiz del Pozo, 2012, p. 4.
An example of this was the case of the Jefferson County School Dist. No. R-1 v. Moody's Investor's Services, Inc. where Moody’s was accused of using an unsolicited rating to pressure the school to use their services, after an unsolicited rating from Moody’s affected Jefferson Country bond subscription. (Lin, 2010, p. 262).

The response to the CI by CRAs to weaken regulation “has been twofold. First, no single issuer represents a significant portion of the revenue of CRAs; therefore, the enticement to produce inflated ratings is constrained. Second, reputation risk deters CRAs from succumbing to rated entities’ interests. The limitations of the “reputation risk” argument” (Staikouras, 2012, p. 96). Unfortunately, the reputation argument from the available data is not supported by empirical evidence or the lessons of the 2008-2009 financial crisis.

IV. REGULATORY RESPONSES TO ADDRESS CI OF THE ISSUER-PAAYS BUSINESS MODEL

Notwithstanding the arguments presented by CRAs, public outrage against what public opinion considered as the culprits of the 2008-2009 financial crisis compel legislators to adopt/increase the regulation and oversight of CRAs. Current regulation tries to control the issuer-pays model CI not by prohibiting it "but, rather subject to procedures to manage it” (García Alcubilla & Ruiz del Pozo, 2012, p. 193) from a corporate governance perspective.

Accordingly, the regulations do not eradicate the CI; they incorporate mechanisms to identify, address and assess CI preventing them from corrupting CRAs decision-making process (Strier, 2008, p. 539). Regulations have tried to enhance the “internal oversight and external accountability” (Manns, 2013, p. 777).

Such an approach is consistent with the other regulatory overhauls following corporates scandals, the Sarbanes-Oxley Act's (SOX), adopted in the US after the Enron Corporation accounting scandal in 2001. The goal there and with CRAs is to improve "Corporate Governance, and internal control reforms emphasized independent oversight and internal risk management, (...) emphasis[ing] on director independence and oversight” (Manns, 2013, p.776).

It is important to keep in mind that current regulations are by no means enough to solve the CI associated with the CRAs, business model. The biggest problem today is that “there is not a credible, viable alternative to the issuer-pays business model and to this day despite been the most important part its remain

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15 In the EU it is only after the financial crisis in 2008-2009 that leads to the adoption of the first compulsory regulation to CRAs.

16 In the case of the US, it was a reform of the regulation already in place.
unsolved in the US [and EU], or have been partially resolved by trying to minimize, reduce the risk the CI of CRAs present.” (Manns, 2013, p.753).

The regulatory responses can be classified into three categories. The first category seeks to correct the issue by enhancing disclosure requirements. The other reforms, want to go one step further and want to change the relationship between issuers and CRAs, and the final category is a call for direct government regulation (Strier, 2008, p. 5343-544).

In a nutshell, the regulatory response the US has three stages. The first prior 2001 where CRA`s were mostly unregulated. The second phase followed the Enron bankruptcy in 2001 that brought them the attention from regulators as they failed to accurately assess Enron situation, from that episode the US adopted the Credit Rating Agency Reform Act of 2006. The goal of that regulation was to improve rating quality by trying to make them more accurate, transparent. The third stage was propelled by the financial crisis of 2008-2009 and ended with the adoption of the DFA the need for more reforms reduce the reference to ratings from legislation, impose civil liability for CRAs and eventually to come up with an alternative business model for CRAs (Strier, 2008, p. 5343-544).

By contrast to the US in the EU, there was no mandatory regulation until 2009, when it adopted Regulation (EC) No 1060/2009 (Legind & Horby, 2014, p. 115). The 2009 regulation was reformed in May 2011 and again in May 2013 when Regulation (EU) No 462/2013 was approved (Legind & Horby, 2014, p. 115). Because of this slow adoption, the EU regulation follows the US experience, and both have similar principles and rules. For that reason, the main provisions of both regulations are analyzed without a reference to them unless deemed appropriate.

Now the main restrictions of the post-financial crisis regulations. CRAs can no longer rate a financial instrument if it helps put it together; analysts are no longer part of fee negotiations (White, 2010, p. 223). Constraining the capacity for issuers to exert influence on CRAs and its personnel. The second set of provisions enhances "transparency; for example, by requiring the rating agencies reveal details on their methodologies, assumptions, and track records in the construction of ratings" (White, 2010, p. 223) CRAs must disclose “the qualitative and quantitative content of credit ratings and of third-party due diligence” (Manns, 2013, p. 771) all to rely on “private accountability tools (…) to facilitate private monitoring and to enlist private plaintiffs to police rating agencies while minimizing direct government expenditures.” (Manns, 2013, p. 772).

An additional measure introduced in the US and EU was to withdraw the regulatory designation given to ratings that determine the type of instruments financial institutions must hold to comply with the regulation (White, 2010, p.
This curves the overreliance by markets and regulation on ratings. For instance, the DFA limits the regulatory use of rating by formally eliminating most of the reference from government statutes and regulation. (Manns, 2013, p. 758). Regulated institutions with the assistance of the regulators must make their own assessment and not rely solely on the ratings (White, 2010, p. 224). Nevertheless, this particular reform “has not had the impact of marginalizing ratings that proponents had hoped would occur. Ratings continue to be a de facto requirement for most debt issues” (Manns, 2013, p. 770) or are regularly incorporated in private contracts. So, the actual impact is probably going to be in the long haul as market actors adapt to this new reality. (Manns, 2013, p. 770).

To cap the CI from long commercial relationships between CRAs and issuers the EU regulation limits the duration to a maximum of 4 years for the case of debt securitizations, accompanied by a cooling off period equal to the length of the expired contract but not exceeding four years (Wittenberg, 2015, p. 687). During that period issuers must rotate or use the service of other CRA; here the idea is to limit CI by diminishing "the economic incentives of CRAs to adjust their fees or ratings in favor of issuers in the interest of continued or additional business" (Wittenberg, 2015, p. 688).

Besides, the EU regulation in an attempt "to mitigate (...) the risk that higher fees are charged (...) for overly favorable ratings, (...) CRAs [have to] ensure that fees charged for the (...) credit rating (and ancillary) services are not discriminatory and are based on actual costs. (...) [Most importantly] fees charged for credit rating services shall not depend on the rating grade or any other result or outcome of the work performed.” (Wittenberg, 2015, p. 688).

Other measures adopted by the US and EU include the introduction of expressed provisions so CRAs can be liable in a civil court for their ratings, trying to ‘improve legal certainty for investors, prevent forum shopping and have a preventive disciplining effect on credit rating agencies.’ Nowadays CRAs can be held liable for “misrepresentations or omissions of material facts” (Macneil & Satragno, 2014, p .196) of their ratings and investors could file a civil lawsuit for the losses they suffer. As a result, this change alone is a significant step in the right direction as historically CRAs were "notoriously insulated from civil liabilities by explicit statutory immunities and the First Amendment” (Lin, 2010, p. 286) that treat them as an “opinion” or protected speech. Nevertheless, it remains to be seen how effective it would be, since there can be contractual limitations either because investors do not have a direct relationship with the CRA or because there is a contractual exclusion of liability or the threshold to show harms is onerous (reasonable and proportionate test) (Macneil & Satragno, 2014, p.196). Manns (2013) consider that regulators should expand the scope of private enforcement against CRAs to "leverage the self-interest of issuers to monitor and
prosecute grossly negligent conduct by rating agencies. This approach would complement (...) ongoing efforts to foster greater competition and accountability in the rating industry” (Manns, 2013, p. 754).

Additional regulations to reduce CI in CRAs and can be summarized as follows:

- **Conflicts at the CRA level:**
  - Half of the members of the Board of Directors (BOD) must be independent directors, and investors must have representation on the boards (Manns, 2013, p. 777).
  - BOD of the CRA must exercise specific oversight roles in examining methodologies and models, accuracy, internal controls, and CI compliance (Manns, 2013, p. 777).
  - CRAs must have an independent chief of compliance and must enforce internal controls to ensure compliance with their rating methodologies and submit annual reports on their compliance with the SEC (Manns, 2013, p. 777).
  - Prohibition on CRAs to issue a rating if the issuer involved represents 10% in the US or 5% in the EU of the total revenues of CRA (Lin, 2010, p. 279). It has been criticized for not been effective or too meaningful because CRAs corporate ratings are from many clients and no single client meets the threshold. (Lin, 2010, p. 279).
  - Transparency requirements: CRAs must disclose:
    - Rating methodologies and procedures used to determine ratings (Lin, 2010, p. 283). Related to this although applicable to issuers is the need to disclose with the registration any preliminary ratings, by all the CRAs involved even if not finally used (Lin, 2010, p. 283).
    - Performance statistic to reveal the historical performance of ratings. (Lin, 2010, p. 283).
    - Under the Cuomo Agreement, all the ratings emitted to an issuer even if not used by an issuer. Only applies to the Big Three17 CRAs and for residential mortgage-backed securities. (Lin, 2010, p. 292).
    - To the regulator, “the list of the largest issuer and subscriber clients.” (Lin, 2010, p. 280).

- **Conflicts at the rating analyst level18**, explicit prohibitions on:

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17 Moody’s, S&P and Fitch.
18 In the US “these conflicts are regulated under Section 15E of the Exchange Act and the SEC Rules and are managed by the codes of conduct [of CRAs]” Lin, B., p.272.
The ownership of rated securities by rating analysts and persons approving credit ratings (Lin, 2010, p. 290-291).

Employees of CRAs from serving as directors or officers of rated entities if the employees participate in the rating process (Lin, 2010, p. 290-291). On top of that, the “internal rules of some CRAs prohibit employees from taking such positions even if they do not participate in the rating process.” (Lin, 2010, p. 274).

The person that does the rating or approves, or determines the methodology or procedure cannot be involved in the negotiation, discussion or approval of the fee with the issuer. (Lin, 2010, p. 280).

Accepting gifts or receiving entertainment in amounts exceeding USD$25 from the issuer if the analyst participates in the rating process or must monitor, approve the rating. (Lin, 2010, p. 276).

To finalize this section, existing regulation, covers most of the CI, particularly at the analyst level, “through outright prohibitions in law and/or the internal rules of credit rating agencies, and through the reporting requirements implemented by credit rating agencies.” (Lin, 2010, p. 291). However, the issuer-pays business model remains like a Damocles sword. So, it is eminent to go over some potential alternatives to it.

A. Alternatives to the issuer-pays business model

Regulators have failed to implement “a credible, viable alternative to the issuer-pays business model and to this day (…) it remains unsolved.” (Manns, 2013, p. 753). In the US two studies evaluating the alternatives to issuer-pays business model, both the GAO19 and SEC20 reports have shied away from making an official recommendation. Suggesting the concern that “the existing reform proposals are underdeveloped and that it may be premature to implement such a significant overhaul” (Manns, 2013, p. 785) to CRAs. For that reason, Macneil (2014) argues that unless the issuer-pays model is removed any new provision to make ratings more accurate would fail to solve the problem and at best would be fine-tuning of the regulations already in place (Macneil & Satragno, 2014, p.194).

Some have tried to solve the problem by increasing competition among CRAs. The problem is that competition21 does not seem to solve the problem. More competition facilitates rating shopping by issuers (Jiang J., p. 608), or result in a quality reduction of the ratings as former market incumbents (Becker B and Milbourn T., p. 513) accommodate new players. More CRAs give the issuer more options to find another CRA to get a higher rating (Bolton, Freixas, & Shapiro, 2014, p.194).

19 Government Accountability Office
21 For support of this view see Staikouras, 2012, p.81.
For example, when Fitch started rating corporate bonds, quality of ratings went down CRAs adopted more lax rating methodologies (Bolton, Freixas, & Shapiro, 2012, p. 5).22

“Competition for CRAs is no “magic potion” to discipline (...) CRAs. In fact, (...) increasing competition is likely to reduce ratings’ quality. (...) [I]n a competitive rating industry, every CRA may have strong incentives to offer inflated ratings to undercut its competitors and attract more clients.” (Staikouras, 2012, p. 87).

The idea to ban the issuer-pays model has not attracted much support; it is considered too extreme or too radical (Macneil & Satragno, 2014, p.194). Furthermore, the free-rider concern previously mentioned is one of the main barriers to transition to an investor-pays model. Therefore, most of the proposals tinker with the issuer-pays model by banning23 the capacity of CRAs to provide ancillary or consultancy services like “market forecasts, estimates of economic trends, pricing analysis, and other general data analysis, as well as related distribution services” (García Alcubilla & Ruiz del Pozo, 2012, p. 4) to the companies they rate (Macneil & Satragno, 2014, p.194).

1. Investor pays model

The first option intuitively seems to go back to the investor-pays model. Supporters argue that is a workable option as small CRAs operate under it24, minimizing the free-rider concerns. Nonetheless, the investor-pays model is no panacea; it has some drawbacks. The main one is that it does not eliminate CI; it simply changes the parties involved. Instead of being the issuer it is now the investor who has the incentives to influence the ratings (García Alcubilla & Ruiz del Pozo, 2012, p. 5).25 Such concerns increase when the CRA revenues are concentrated in a few investors, as it occurred with investment banks in the subprime debacle of the 2008-2009 financial crisis.

The second limitation is the free-rider problem. In this model, revenues come from subscribers. If investors can get access without paying then there is no market. Modern technology can make the free ride problem even harder to handle than in 1970 (García Alcubilla & Ruiz del Pozo, 2012, p. 5). Moreover, the CRAs

22 See also Becker & Milbourn, 2011, p. 513.
23 See Article 6(2) EU CRA Regulation and Annex B para. 4; and for the US, 17 CFR 240.17(g)–5(c) and SEC Federal Register 73(123) (25 June 2008).
24 In the US of “the ten CRAs registered as NRSROs, seven operate predominantly under the issuer-pays model, while the remaining three operate mainly under the subscriber-pays model” (García Alcubilla & Ruiz del Pozo, 2012, p. 4).
25 See also Staikouras, 2012, p.104.
that use the investor pay model nowadays are small and cater to a niche in the market.

Another problem with the investor-pays model is that it would be limited to the investors that can pay for the ratings, making accessibility hard for smaller investors. The issuer-pays model allows ratings to be publicly available so large investors do not have an advantage over smaller investors (García Alcubilla & Ruiz del Pozo, 2012, p. 7).

2. Public CRAs

The second alternative is to create a CRA following the public utility model. It would be publicly funded, and would function by allowing investors to compare the ratings with the ratings private CRAs issue (García Alcubilla & Ruiz del Pozo, 2012, p. 9). This proposal has been debated mainly in Europe as showed by the EC CRAs consultation that put it on the table.

The downsides to this proposal can be summarized:

- It would not be free of CI. The involvement of public entities could make it susceptible to political influence, pressure from large issuers (banks, industrial employers, and government themselves) (García Alcubilla & Ruiz del Pozo, 2012, p. 9).
- The official status could send a mixed signal to the market that the rating has or provides a quality stamp, only shifting current reliance on private CRAs to the dependence in the public CRA. (García Alcubilla & Ruiz del Pozo, 2012, p. 9.)

3. The Cuomo Agreement

Of all the solutions available to date, the author favors the so-called Cuomo agreement,26 approved by the “Big Three”27 in the state of New York. The agreement applies only to ratings of residential mortgage debt securities in the state of New York, and is to the best knowledge of the author the only one implemented. It does not prohibit the issuer-pays business model but modifies it. Under the agreement, the CRAs are paid upfront by the issuer (Macneil I and Satragno L, p .195), and before the rating is issued (Lin, 2010, p. 292), eliminating the chances/incentives to inflate ratings. Most importantly, it requires the CRAs to disclose all ratings performed, regardless of how the ratings end up being used in the debt offering (Lin, 2010, p. 292), eliminating the possibility of rating shopping as well.

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26 Named after the New York State Attorney in 2008 Andrew Cuomo.
27 S&P, Moody’s and Fitch
4. The Franken Rule

Perhaps the most interesting alternative to date is the Franken Rule that came in the DFA. The Franken Rule to the best of my knowledge is not in force (Bongaerts, D..2014, p. 24). The Franken Rule operates as an option for the SEC if it does not develop “its own alternative to address the [CI] arising from the issuer-pays system” (Manns, 2013, p. 784). It requires “the creation of an independent commission to select rating agencies for structured finance products using a lottery or random assignment system with an eventual transition to performance-based selection” (Manns, 2013, p. 784). The Mechanism would prevent rating shopping, as the appointment of the CRA is done by the Board and not directly by the issuer.

After analyzing the alternatives to the issuer-pays business model, and the complexities to replace the model, aggravated by the fact that the regulators to this day have not endorsed an alternative model (Manns, 2013, p. 785). It would seem that the best solution “until regulators have found a substitute that is proven to be superior” (Lin, 2010, p. 312) is to adopt the Cuomo agreement by extending it to all types of ratings not only to residential mortgage-backed securities. In this way, the incentive to give higher ratings would be lower as the issuers pay CRAs “up-front for their rating, and not contingent on the report” (Ponce, 2012, p. 305).

It should be compulsory that CRAs publish all ratings they paid for, and Issuers would also have to reveal all the ratings they hired -- even bad ones (Bolton, Freixas, & Shapiro, 2012, p. 26) for a security; this way shopping rating is eliminated.

V. CONCLUSION

The current regulation of CRAs corrects the most egregious CI that the corporate scandals and financial crisis highlighted especially at the analyst level (Manns, J, and p.811). Nevertheless, the possibility of inaccurate ratings influenced by issuers remains, and the only way to manage it depends on "the effectiveness of a combination of disclosure, surveillance, and enforcement measures” (Lin, 2010, p. 296).

Thus, one step forward in this direction would be extending the Cuomo Agreement to all ratings until a better alternative is proven superior (Lin, 2010, p. 312) or presented to reduce the CI associated with the issuer-pays model. Acting as an ex-ante control to secure the accuracy of ratings.

The use of the Cuomo Agreement needs to be complemented by reducing the use of ratings in regulation, and by encouraging/requiring Investors to do their

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28 For the moment, the Franken Rule has been postponed while the SEC investigates other solutions.
own risk assessments, so they do not take ratings at face value. The governance reforms already implemented\textsuperscript{29} should be supported. Of course, these regulations and interaction of them require constant monitoring and evaluation to see if they are working the intended way.

The impact of some of them like the reduction of overreliance on ratings will not work overnight and are medium and long-term proposals. Other reforms like private and public enforcement against CRAs are the last tool in the arsenal to discipline and punish CRAs for inaccurate ratings and to secure accountability of CRAs since they work ex-post when something has gone wrong. All stakeholders have a role to play to make sure that ratings work better.

\textbf{REFERENCES}


\textsuperscript{29} Please refer to the measures discussed in section 4 of this paper.


