

Oana Mihaela MARIOARA (ORHEIAN)  
Academy of Economic Studies, Bucharest  
Ioana Gabriela GRIGORESCU  
Romanian-American University, Faculty of Managerial Informatics

# LEGAL ASPECTS OF THE REGULATORY FRAMEWORK FOR CREDIT RATING AGENCIES.

Literature  
reviews

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Credit agency

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G24, K20, N20

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## Abstract

*This article makes an analysis of the main regulations used by the credit rating agencies on the financial market. The article describes the main specific legislation on credit rating agencies existing on the market.*

*Credit rating agencies are issuing independent opinions on the reliability of an entity, of a debt, of financial obligations, or of a certain financial instrument. The credit ratings issued by the credit rating agencies established in the European Union are analysed by investors, debtors, issuers and governments, helping all these entities in making any decisions on investments and financing. These ratings may also serve as reference for determining their own funds, necessary to ensure the solvency or reference helping the investors in assessing any risks related to their investment activities. Rating agencies and the products they offer on the international capital market are subject of various researches, which mainly refer to market structure and organization, to the architecture of agencies` s rating systems, to the rating functions, to the controversies concerning rating activity, the role of rating agencies and rating quality.*

## Introduction

The rating process is meant to be a transparent one, independent and objective, so as the assessing rating agency to gain market recognition by the investors` s acceptance of the agency rating and subsequently, for the agency to maintain its good reputation.

The rating agencies have standardized their procedures for elaborating the risk grade and are disposing clear rules of corporate governance (so called "Code of Conduct"). The rating standard elaboration process can be summarized as it follows, (www.standardandpoors.com, www.moodys.com):

Appointment the risk analyst; the analyst is doubled by an experimented analyst and, eventually, by a team of experts;

- Research on the analysed corporation from all available sources, including meeting the corporation`s management, meeting with financial director and general manager; the list of question to be addressed to the management may or may not be send to them before the meeting; the latter case (when the list if not to be send), is intended to measure the spontaneity; (according with Standard & Poor`s)
- Appointment of a committee to finalize the rating procedures;
- The principal analyst presents the company and proposes a certain grade / qualificative, then the rating is determined by voting method. If there is no accord of opinions, there are appeal procedures which may assume increase the number of the members of the risk committee, with more experienced analysts;
- The rating is then communicated to the company which may request its review / reconsideration and bring, for this purpose, additional information; yet, the rating review/reconsideration is not a common method. After the risk committee had determined its final rating, this is being disseminated by the company and / or the rating agency.

Regulating the rating agencies market is performed by the restrictions imposed by SEC, (Securities and Exchange Commission) through the Nationally Recognized Statistical Rating Organization Standards (NRSRO).

These standards first appeared on the market in 1975. The NRSRO legislation was amended over several years, among the most important documents being Credit Rating Agency Reform Act of 2006, then CRA Reform Act of 2008, 2010, a document which sets the criteria that an agency must meet in order to become NRSRO, as well as the general conduct framework.

According to the annual Report of SEC, from December, 13<sup>th</sup>, 2013, there are 10 NRSRO agencies, such as: AM Best Company Inc., registered at September 24<sup>th</sup>, 2007; DBRS Inc., registered at September 24<sup>th</sup>, 2007; Egan-Jones Rating Company, registered at December, 21<sup>st</sup>, 2007; Fitch Rating Inc., registered at September, 24<sup>th</sup>, 2007; Japan Credit rating Agency Ltd, registered at September, 24<sup>th</sup>, 2007; Moody`s Investors Service Inc., registered at September, 24<sup>th</sup>, 2007; Morningstar Credit Rating LLC, registered at June, 23<sup>rd</sup>, 2008; Kroll Bond Rating Agency Inc., registered at February, 11<sup>th</sup>, 2008; S&P Ratings Services, registered at September, 24<sup>th</sup>, 2007; HR Ratings de Mexico S.A. de C.V., registered at November, 5<sup>th</sup>, 2012. Most agencies have their headquarters in USA, except for Japan Credit Rating with headquarters in Japan and HR Ratings de Mexico, with headquarters in Mexico.

The National Recognized Statistical Rating Organization (NRSRO) is a rating agency which issues credit ratings certificates to the institutional qualified buyers, related to: financial institutions, brokers, dealers or insurance companies, corporate issuers, issuers of assets guaranteed securities; issuers of government securities, municipal securities issuers or securities issued by a foreign government, or a combination of several categories of issuers, as above mentioned.

The main directives to be mentioned are: Directive 2003/6/CE; Directive 2003/125/CE; Capital requirements Directive (CRD) 2006/48/CE; MIFID Directive (Markets in Financial Instruments Directive); Directive 2004/39/CE, on financial institutions, Basel II Agreement, which mention the criteria which an agency must meet for its rating to be recognized in order to determine the minimum capital requirements of financial institutions.

Moreover we have to mention three main Regulations related to the credit rating agencies, namely: Regulation (CE) no.1060/2009 of European Parliament and European Council of September, 16<sup>th</sup>, 2009; Regulation 1095/2010, which had established ESMA (the European Securities and Markets Authority) and Regulation 513/2011.

The European Council imposed for the establishment of an independent European agency, ESMA - European Securities and Markets Authority. This authority was founded by adopting the Regulation 1095/2010. ESMA`s purpose if to contribute to ensuring the stability of European Union`s area financial system by providing the integrity, transparency, efficiency and proper functioning of securities market on the Union`s territory.

ESMA promotes the convergence of the institutions dealing with regulation on securities in

member countries and, in horizontal plan, related to the activity between the financial sectors from the member countries, working closely with the European banking authority (EBA), as well as with the European insurances and occupational pensions authority (EIOPA).

ESMA is responsible for supervision and ensuring a minimal relevance of the rating system within euro area. Concerning the mechanism of granting a rating, the EU Regulation 1095 on ESMA, provides that a rating agency within a third country must meet those criteria which are general conditions necessary for the integrity of credit rating activities provided by an agency. The purpose of meeting these criteria is to prevent the necessity for an intervention of any competent authorities and other public authorities of those third countries in the content of the rating resident within Union territory.

Through these interventions, ESMA is imposing an appropriate policy concerning the management of any conflict of interest, the rotation of the rating analysts and the existence of a permanent and ongoing information disclosure procedure. ESMA regulation also provides that all rating users are being guided to education, so as to diminish their credulity regarding the rating grades issued by rating agencies. Otherwise, the rating users should not strictly base on the agencies' s ratings.

The Regulation CE no.1060/2009 of European Parliament and European Council, September 2009, concerning the rating agencies, requires the rating agencies to comply with a professional conduct code, with the main goal of reducing any potential conflict of interest, to guarantee a high quality and enough transparency of ratings and ratings granting process. Therefore, further additional amendments were introduced by the EU Regulation 513/2011, of European Parliament and European Council: the Regulation gave to the European Securities and Markets Authority (ESMA) the competence to register and supervise the credit rating agencies.

The current Regulation amends the current regulatory framework, applicable to credit rating agencies. Some important and relevant issues were approached, such as: conflict of interest due to the model \*issuer pays\*, disclosure of information on structured financial instruments, and the regulations framework must be reviewed after it has been applied for a reasonable time period, so as to assess if and how the regulation solves the reported issues.

The credit ratings, granted for regulatory purposes, or other purposes, have a significant impact on investment decisions and on the image and issuer' s financial attractiveness. The rating agencies have the important responsibility to the investors and issuers, to guarantee that the provisions of the EU Regulation 1060/2009 are

being implemented, so as their ratings are independent, objectives and have an adequate quality.

Another study related to the regulation of the EU and USA rating agencies is Champsaur' s, 2005. The author captures the key concepts of rating' s content itself, as well as the difference between the meaning given to the rating content by the rating agencies (opinion), issuers, investors and authorities, (quasi-recommendation and normative value, derived from rating-dependent regulations.) and financial market (uncertain meaning, controversial informative value).

Describing the business model of rating agencies, Champsaur (2005, pp. 14 – 17) analyses the potential conflict of interest arising from: issuers rating payment, auxiliary services provided by rating agencies and the possibility of selling confidential information on issuers to various subscribers. The author also outlines the answer of the “Code of conduct principles for the rating agencies” of IOSCO (2004) to the issues previously mentioned. In the same paper work, (2005, pp. 29 – 35), the author is militating for the necessity of regulation of rating agencies, given the potential danger posed by incorrect ratings on the stability the financial system. In order to prevent such systemic risk, the regulation can set two directions: increase the accuracy of ratings and minimize the use of ratings in regulations as well as in private contractual clauses. By regulation, the IOSCO (2004) conduct Code, which has to be followed by the rating agencies, would receive legal guarantees. (Einig and Duff, 2007, pp. 124 - 128).

Rating agencies have a similar role of external auditors. Therefore, the rating can be used as instrument in business transactions (mergers and acquisitions), it strengthens the contracts, reduces the transactions and monitoring costs.

The role of the rating agency is to assess, in an objective and independent way, the risks of bankruptcy or default of an economic actor, issuing debt securities or bonds. The agencies are informing the investors on the risks they have to take when borrowing a company or a country.

Through the credit rating, the debtor companies benefit from the credibility of rating agencies. The credibility transfer is ensured by the main service provided by these agencies: signaling service (Dittrich, 2007).

**As conclusion**, the European Securities and Markets Authority (ESMA) exercise a continuous supervision of the credit rating agencies, in particular of the rating methods. It does not interfere in the credit rating content or in the methods used by rating agencies. ESMA is required to a close cooperation with EBA (European Banking Authority), with EIOPA, (European Insurance and Occupational Pensions Authority), with sectoral competent authorities in the exchange

of information process. It may disclose confidential information to central Banks, to European Central Bank, to European Systemic Risk Committee, as well as to public authorities.

The rating agencies should voluntarily implement the Code of fundamentals for rating agencies, published by the International Organization of Securities Commissions (IOSCO Code).

All these regulations, in terms of assessed entity, bring value to the performed rating, allowing the access to a better legal treatment makes the rating more attractive to business partner and, eventually, improve its financing conditions.

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