Accountability and the Second Line of Defence : A guide to Practical Policy-ing for Ethical Global Credit Rating

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Nominated Global Prize

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EN Credit Rating Agencies are essential to the smooth running of the global financial system due to their informational, transactional and regulatory value. Their recent failure in holding the "second line of defence" against financial crisis brought to the fore key accountability issues. These include the lack of competition, conflict of interest and perverse incentives. This paper proposes a practical "policy package" of regulatory policy options in the spirit of promoting ethical global finance. This policy ensemble involves the establishment of a public sector rating agency and detailed specifications on the separation Credit Rating Agencies' rating and consultancy and structured finance services. It also includes the 'freezing' of ratings for up to six months from the introduction of new products for which no precedent is available. This is in light of the iden-

tification of the core problem in recent times of dealing with innovation and the valuation of new and complex instruments.

FR Cet article fournit des options politiques pratiques pour la régulation des agences de notation financière dans l'esprit de la promotion d'une éthique globale en finance. Les agences de notation sont essentielles pour le bon fonctionnement du système financier global en raison de leur valeur informationnelle, transactionnelle et réglementaire. Leur échec récent pour assurer la "deuxième ligne de défense" contre la crise financière a mis en évidence des questions clés au niveau de la responsabilité. Il s'agit notamment du manque de concurrence, de conflits d'intérêt et des incitations perverses. Cet article propose un "paquet de politiques" pratique de réglementation à examiner. Ce paquet inclut la création d'une agence de notation du secteur public et des spécifications détaillées sur la séparation des agences de notation et les services de consultants et de services dans le domaine de la finance structurée. Il comprend également un "gel" temporaire des notations. Ceci s'inscrit dans la ligne de l'identification du problème fondamental de la période récente lorsqu'il s'agit de traiter de l'innovation et de l'évaluation des nouveaux et complexes instruments financiers.

« There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful. »
(Thomas Friedman)

"Il y a deux superpuissances dans le monde aujourd'hui : les États-Unis et Moody's. Les États-Unis peuvent vous détruire en vous envoyant des bombes. Moody's peut vous détruire en abaissant la note de vos obligations. Et croyez-moi, ce n'est pas clair parfois qui est le plus puissant."
(Thomas Friedman)

Executive Summary

This paper is based on the premise that *Credit Rating Agencies are essential to the smooth running of the global financial system* due to their informational, transactional and regulatory value. Here, emphasis is placed on the regulatory value of Credit Rating Agencies and their role in the second line of defence against financial crises.

It is the recent failure of Credit Rating Agencies in holding the second line of defence that prompted this enquiry. Here, their role in the current financial crisis brought to the fore key issues to address. These are the lack of competition, conflict of interest, perverse incentives, low accuracy, endemic pro-cyclicality and systemic regulatory dependence on credit ratings.

This study has shown that the *current regulatory framework is inadequate* to address and resolve the above-mentioned issues. Based on a cursory review of relevant literature, seven categories of regulatory proposals were identified. These are nationalization, the abolishment of official recognition, the provision of additional information, the introduction of legal liability, the separation of consultancy from advisory functions and the weakening of barriers to entry.

After applying the options analysis public policy tool to assess the relative merit of each of these regulatory options vis-à-vis the issues mentioned above as well as the political and implementation feasibility, a *'policy package'* with specific modalities is proposed. This involves the establishment of a public sector rating agency and the provision of two options to Credit Rating Agencies. These options are either; (1) delegate rating function to the public sector rating agency and continue with the structured finance/ consultancy arm of their business or; (2) cease the structured finance/ consultancy activities and focus only on providing ratings.

Here, it is recommended that should the Credit Rating Agencies choose the second option, the following new set of rules and regulations should apply – (1) ratings should be paid for by investors and not by issuers; (2) performance management by regulators with punitive repercussions should be put in place; (3) additional information beyond ratings should be supplied; (4) regulatory structures and processes that rely on credit ratings should use aggregated ratings of licensed Credit Rating Agencies.

Finally, it is proposed that there be a 'freezing' of ratings for up to six months from the introduction of new products for which no precedent is available. This is light of the identification of *the core problem, particularly in the current financial crisis, as dealing with innovation and the valuation of new and complex instruments*.

Introduction

It has been argued that the current global financial turmoil, touted as the worst since the Great Depression, is taking place because regulatory lines of defence failed to hold and prevent the crisis. Sequentially, risk management at firms, then market and official analysts and finally established regulatory bodies each failed to halt the financial meltdown which has pushed most major economies around the world to the brink of recession and caused significant slowdown and failure of some emerging market economies.

Cette affirmation est la reconnaissance du rôle capital et indispensable que les agences de notation jouent dans le système financier global et, comme démontré par les récents événements, le grand impact de leur incapacité à s'acquitter efficacement de leurs mandats pour la stabilité financière globale.

The focus of this paper is on the second line of defence in general and Credit Rating Agencies (CRAs) in particular. This is in recognition of the vital and indispensible role that the CRAs play in the global financial system and, as demonstrated by recent events, the great impact of their failure to effectively fulfil their mandates on global financial stability.

With this in mind, this paper is divided into seven sections. (1) An overview of CRAs; (2) The role of CRAs in the current financial crisis; (3) Key issues to address; (4) Recent regulatory developments; (5) Proposed regulatory options; (6) Options Analysis and; (7) Recommendations.

Overview of CRAs

Origins: CRAs trace their roots to more than a century ago when investment in railroad began. [1]In the late 1860s Henry Poor published a manual that provided information for investors – a lucrative business which John Moody also established in 1910 by publishing a book analyzing railroads and their outstanding securities and assigning ratings to them. By the 1930s, investment policies requiring that bonds be rated were instituted. Today, there are three main international CRAs and a plethora of national and regional CRAs around the world.

L'origine des agences de notation remonte à il y a plus d'un siècle, quand ont commencé les investissements dans les chemins de fer. Vers la fin des années 1860, Henry Poor a publié un recueil d'informations sur ces projets à l'intention des investisseurs. Cette activité dont John Moody fut également l'un des pionnier s'est avérée lucrative. Moody a établi la notation en tant que telle par la publication en 1910 d'un livre qui analysait les chemins de fer et attribuait une note aux titres financiers correspondants.

Function: Henry Poor and John Moody started analysing and rating railroads after realizing that investors often lack the information to determine the soundness of their investment. In the same way, today, rating agencies deal with principal-agent problems and asymmetric information [2]. Here, the ratings reflect the CRA's estimate of the probability of default over a given period. CRAs therefore fall under the second line of defence since, like auditors, investment analysts and journalists, they act as 'gatekeepers' of investment-related transactions between market participants. In this way, CRAs play a critical informational, regulatory and transactional role in the global financial system.

Modus Operandi: A credit rating is defined as an "opinion forecasting the creditworthiness of an entity, a credit commitment, a debt of debt-like security or an issuer of such obligations, expressed using an established and defined rating system" [3]. A rating agency derives its rating from both publicly available information and private information provided by firms and analysts. This information then goes through the rating agency's credit model to produce a rating [4]. These ratings signify financial soundness and regularity in interest and principal payments. They range from AAA for the highest quality bond instruments to D for instruments in default.

Une notation de crédit est définie comme une « opinion qui prévoit la solvabilité d'une entité, d'un engagement de crédit, d'une dette ou d'un actif analogue, ou encore d'un émetteur d'obligations et qui s'exprime en utilisant un système de notation établi et défini ».

1. Tara Perkins, 2007, *Misguided or Misunderstood?* Globe & Mail, 7 September 2007.
2. Richard Portes, 2008, *Rating Agency Reform*, www.voxeu.com
3. Amelie Champsaur. 2005. *The regulation of credit rating agencies in the U.S, and in the E.U: Recent initiatives and Proposals.* http://www.law.harvard.edu/programs/pifs/pdfs/amelie_champasaur.pdf
4. Richard Portes. 2008

Role of Agencies in the current financial crisis

Although there are several ways to explain the evolution of the current financial crisis, the one which best explains the role of CRAs is the one that sees the current financial crisis, like most financial crises before it, as being triggered by the emergence of innovation. This time, instead of the steam engine or the radio, the crisis emerged from the development of a “new tool of financial engineering” which, as in previous crises, investors were wary of at first before rushing in upon seeing the extraordinary returns which lead to upward surges in asset prices that eventually burst and petered out [5].

More specifically, complex financially structured products came into the market when banks started using an ‘originate and transfer’ approach to housing loans. These loans, a large proportion of which were sub-prime, were then securitized by investment companies who shopped around for higher ratings before selling the instruments to investors.

In this scenario, even the more sophisticated risk-hungry investors did not know how to value these new assets, and so had to rely on and trust the ratings provided by the CRA involved in the securitization [6]. The CRAs, encouraged by their own incentives heeded underwriters’ assurances of the power of pooling to decrease the probability of default and their ability to predict despite a limited track record. As these structured products did not trade, and were sold only over the counter, their price transparency and market liquidity was low [7].

Les trois principales agences de notation “étaient au courant des problèmes graves, mais elles ont continué leurs pratiques qui ont bénéficié aux émetteurs des obligations en négligeant les intérêts des investisseurs qui comptaient sur les notations de S & P, Moody’s et Fitch”.

Because of this, it is widely believed that the CRAs failure to provide correct ratings on these high risk products and hold the second line of defence played a crucial role in the current financial crisis. This lead the US Congress House Oversight and Government Policy Committee to recently hold a hearing which concluded that the top three CRAs “were aware of serious problems but continued company practices which benefited the bond issuers while disregarding the interests of the investors who relied on S&P, Moody’s and Fitch ratings” [8].

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5. Carmen Reinhart, 2008, *Reflection on the International Dimensions and Policy Lessons of the US Subprime Crisis.* www.voxeu.com
6. Guillermo de la dehesa, 2007, *How to avoid further Credit and Liquidity Confidence Crises.* www.voxeu.com
7. Ibid
8. US Congress, 22 October 2008, *Transcript: House Oversight and Government Policy Committee*. http://oversight.house.gov/story.asp?ID=2250Delicious Digg Facebook reddit Technorati

Key Issues to address

There are several problems associated with the CRAs that prevent them from performing their role more effectively. These are linked to key issues that need to be addressed in order to more fully understand the areas in need of reform.

No Competition- Firstly, it has been observed that there are some natural monopoly characteristics in the credit rating industry because of network effects [9]. Network effects here refer to how investors want consistency of ratings across issuers. The natural monopoly also stems from the barriers to entry created by regulators who rely on ratings and as such use stringent criterion to determine whether or not an agency holds this regulatory license. CRAs also require highly qualified analysts, as well as "high tech" and sophisticated rating methodologies with are proprietary [10]. In this way, the credit rating industry displays the same quality deficiencies (in terms of accuracy, lack of rigor and innovation) evident in any monopolistic market.

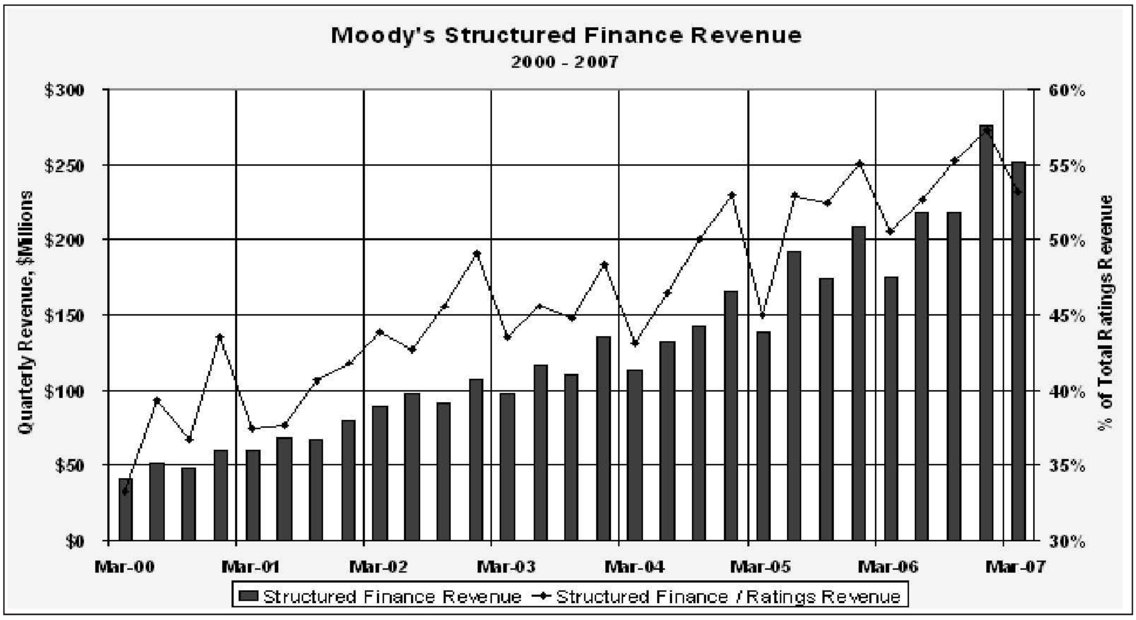
Conflict of Interest – Secondly, and this is the most expansive critique of CRAs, there is an apparent conflict of interest that exist in the business models of CRAs which allows them to first advise on how the construction of a security would affect its rating and then issue a rating that confirms its advice – earning two separate fees in the process. (Fig. 1). For example 44% of Moody's revenues in 2006 came from its structured finance activities [11]. This conflict of interest potentially reduces the objectivity of the ratings provided by CRAs and leads to the problem of perverse incentives in the rating process.

Il y a un évident conflit d'intérêts dans les modèles d'affaires des agences de notation qui leur permet d'abord de donner des conseils sur la manière dont la construction d'un actif aurait une incidence sur sa notation et ensuite d'émettre une note confirmant son conseil – ce qui les fait gagner doublement dans le processus.

Incentives – Thirdly, as is evident from what was alluded to above, there is an apparent incentives compatibility issue with CRAs. In the first instance, CRAs have an incentive to give high ratings in a situation where because the issuer pays for the ratings, he may also shop around for the most favorable rating ('best deal'). In the second instance, due to the same dual business model, CRAs also have incentives to ensure that securitization takes place as this generates more business to them by providing more products to rate. To illustrate this, Figure 2 below shows how the revenue of the three big CRAs increased during the time leading up to the current implosion of the global financial system.

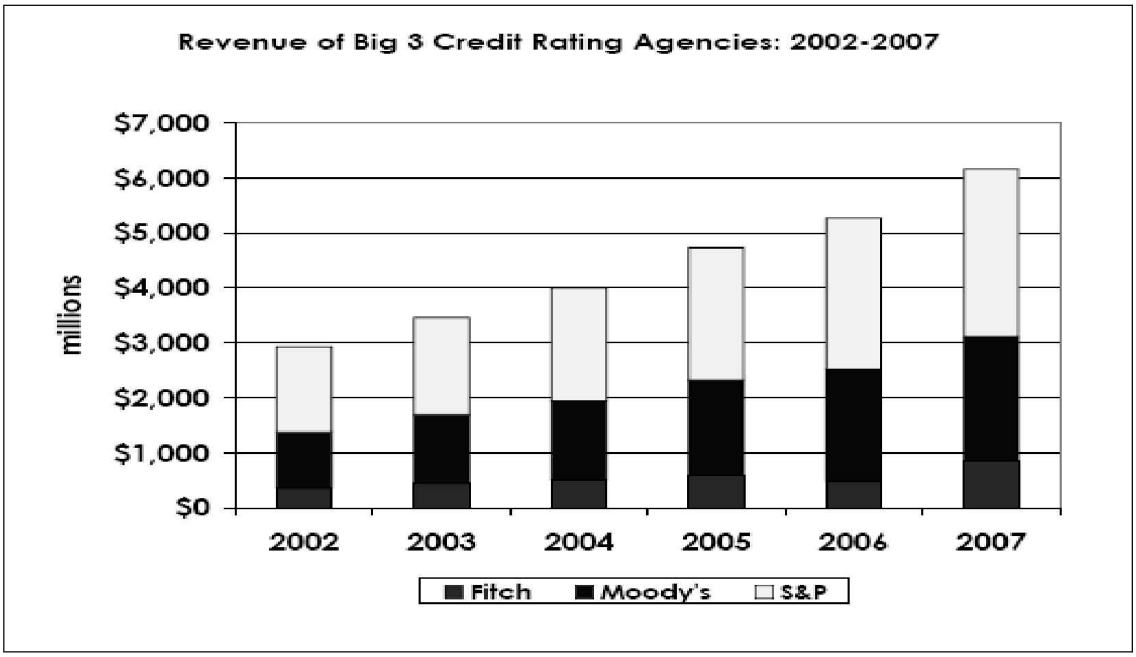
9. Richard Portes, 2008.
10. Amelie Champsaur. 2005.
11. Richard Portes, 2008.

Figure 1 : Moody's Structured Finance Revenue



Source: www.lewrockwell.com

Figure 2 : Revenue of Big 3 CRAs (2002-2007)



Source: www.lewrockwell.com

Accuracy and Pro-Cyclicality – Fourthly, the accuracy of CRAs has been questioned. Agencies are blamed for reacting ex post rather than anticipating defaults. In this way, the ratings are not only lagging indicators [12] but also *pro-cyclical* creating the her-

12. Ibid

ding effects, and magnifying instability as they did during the Asian Financial Crisis. In this crisis, as in the current crisis rating agencies, following their pro-cyclical tendencies, overreacted in their effort to distract the investing public from their laxness of the past few years by strict standards going forward [13] creating the de-stabilizing herding effects mentioned here. Further more, critics have highlighted how the agencies' data and their models are suspect. For example, in rating the securities involving sub-prime mortgages, the agencies are said to have used data from an extended period of rising house prices, during which doubtful mortgages had been validated as householders' equity grew [14]. This led, in part to the inaccuracy of the ratings they provided for these products. With regards to the models simulations CRAs used, it was noted that these may not be helpful when markets become so disorderly that they exceed the models' parameters and tail risk occurs. This is exacerbated by the questionable used of the same metric to evaluate sovereign risk, corporate bond risk, and complex instruments like collateralized debt obligations [15]. It is because of these and other accuracy issues that, some literature points to the fact that rating agencies do not add value. This is because the quality of information they provide is believed to be no better than that which a good analyst could extract from publicly available data. The questionable accuracy has prompted several detailed studies casting doubt on their ability to assess credit quality better than measures based on market spreads or to predict major changes [16].

Les agences de notation sont responsables car elles réagissent a posteriori plutôt que d'anticiper un défaut de paiement. De cette façon, les évaluations ne sont pas seulement des indicateurs retardés, mais aussi pro-cycliques, qui créent des effets domino et une instabilité grandissante comme ils l'ont fait pendant la crise financière asiatique.

The Dependance of Regulators

Regulatory Dependence of CRAs – The final key issue to consider is the dependence of regulators on rating agencies. This extends the scope that stakeholders with vested interests should consider when addressing CRA-related regulatory issues and reflects the effects of poor ratings on financial stability. A case in point here is the dependence of Basel II's capital adequacy standards for banks on ratings. This is particularly problematic in a scenario in which credit ratings do not adequately reflect credit risk. Here, "the banks' capital structure might give the illusory impression that it constitutes a sufficient cushion against risk, which could threaten the safety and soundness of the banking system" [17]. The same is true for the U.S. National Recognized Statistical Rating Organization status, whereby a wide range of investors are required not to hold securities whose ratings are

13. Carmen Reinhart, 2008.
14. Ibid
15. Ibid
16. Levich et al, 2007. *Credit Rating Agencies and the Global Financial System.*
17. Amelie Champsaur. 2005.

below ‘investment grade’, and ratings affect the risk weightings of banks’ assets in calculating capital adequacy ratios [18].

Recent Regulatory Developments

Annex 1 shows the current regulatory framework for CRAs. As these are beyond the scope of this study, IOSCO, the main regulatory tool as well as recent regulatory developments in the European Union and in the United States shall be briefly highlighted.

IOSCO – The International Organization of Securities Commissions published its Code of Conduct Fundamentals for Credit Rating Agencies in 2004. This code focuses on voluntary “corporate governance rules designed to (1) ensure quality and integrity of the rating process; (2) remain independent and avoid conflicts of interest; (3) assume their responsibility to market participants through greater methodology transparency and adequate treatment of confidential information provided by issuers” [19]. The key shortcoming of these provisions is that IOSCO does not address the issue of the enforcement of the code. Instead, it leaves enforcement to either national regulators or market mechanisms [20] which, in light of the current crisis, have been ineffective.

Le Code de conduite des agences de notation publié en 2004 met l’accent sur l’adoption volontaire de « règles de gouvernance d’entreprise visant (1) à assurer la qualité et l’intégrité du processus de notation ; (2) à rester indépendantes et à éviter les conflits d’intérêts; (3) à assumer leur responsabilité envers les participants au marché grâce à une plus grande transparence des méthodologies et à un traitement approprié des informations confidentielles fournies par les émetteurs ».

European Union – October this year saw the drafting of a law designed to prevent conflicts of interests between CRAs and their clients in the EU. The legislation aims to forces CRAs to disclose their working methods and to encourage the emergence of new agencies. Under the draft proposal, CRAs will not be allowed to combine their work with consultancy and specific rules are given on how staff members are paid and how long they can work with clients. These are that (a) pay should be determined primarily by the quality, accuracy, thoroughness and integrity of their work; (b) for companies with more than 50 staff members, a four-year time limit would be placed on work with individual clients to prevent relationships from becoming too close and; (c) there would then have to be a two-year break before the individual worked with the same client [21].

United States – In the U.S., preliminary steps to address the issue of CRAs in light of their role in the current financial crisis were taken in the form of a hearing by the House Oversight and Government Policy Committee. Here, the current heads of S&P, Moody’s and Fitch were issued with firm statements after testifying

18. Richard Portes, 2008.
19. http://www.iosco.org/pubdocs/pdfIOSCOPDI151.pdf
20. Ibid.
21. Stephen Castle, 29 October 2008. *EU prepares tight rules on credit rating agencies*. International Herald Tribune.

with U.S. legislators announcing clear intentions to hold CRAs accountable for their actions [22]. This may be impetus for future EU-like regulatory procedures to be taken in the near future.

Proposed Regulatory Options

With these key issues in mind, several regulatory options can and have been proposed. Apart from their role in the current financial crisis, reasons behind calls for regulation stem from studies which have refuted the claims that reputational concerns lead to reliable ratings by CRAs. Here, it was previously argued that CRAs provide accurate information to market participants in order to safeguard their reputation of ensuring reliable ratings. However, it has been noted that "worrying about reputation is not the same as worrying about providing reliable ratings" [23]. This is because CRAs can be too conformist, too conservative or too bold precisely because they worry about their reputation [24]. It is for all the reasons mentioned here and above that various proposals for the regulation of CRAs have been put forward. A brief description and discussion of each option shall be given before their respective merits are analyzed.

Le maintien du statu quo actuel, ne peut et ne résoudra pas les problèmes liés aux incitations.

Option 1: Status Quo - This will entail leaving the current status quo as it is, since market participants will lobby against anything stronger. Moreover, the French Autorité des Marchés Financiers, believe that the voluntary code has been implemented in a "globally satisfactory manner" [25]. The main problem with this proposal is that it does and cannot solve the incentives problems mentioned above.

La première proposition à considérer est la nationalisation des agences de notation. Les notations émises par les agences devraient donc être considérées comme étant des biens publics et leur financement devrait être garanti par la collectivité.

Option 2: Nationalizing the Agencies – The first proposal to be considered is the nationalization of the CRAs. This comes from the classification of ratings as public goods which should therefore have public funding as they are essential in ensuring that the global financial 'plumbing' operates smoothly. Some have taken this proposal even further by calling on governments to set up a public rating agency (PRA) [26]. The key feature of such a PRA is that it would not aim to make profit and would not have an interest in providing overly generous rating thus avoiding the incentives and conflict of interest problems mentioned above. It is proposed that such a PRA be funded with tax payers' money, that it should be organized at the European level and combined

22. US Congress, 22 October 2008.
23. Beatriz Mariano, 12 July 2008, *Do reputational concerns lead to reliable ratings?* www. voxeu.com
24. Ibid
25. Ibid
26. Roel Beetsma, October 27, 2008. *The ase for public sector credit rating agencies.* www.rgemonitor.com

with the European Financial Services Authority (EFSA) in the E.U. The main problem with this proposal is overcoming the lack of political will combined with the powerful lobby that is sure to be presented by the CRAs.

Abolir la reconnaissance officielle des agences de notation impliquerait l'élimination de la licence de régulation de ces agences.

Option 3: *Abolish official recognition of CRAs' ratings* – This proposal would involve eliminating the regulatory license of CRAs by removing the NRSRO designation and merely requiring agencies to register with the regulators. Intuitively, it can be seen that awarding CRA ratings with official recognitions places the ratings above suspicion by investors who then fail to conduct their own risk assessment before making investment decisions. No official recognition will force investors to see ratings as one of many tools that can be used to inform investment decisions, and thus allow them to gauge risk more accurately. For CRAs the barriers to entry and almost 'god-like' status will be removed. The main problems with this proposal are that such a move will increase the regulatory burden on the regulators and would suppress the role of CRAs in Basle II, which, after all the effort put into crafting it, is likely to encounter great opposition [27].

En rétablissant les abonnements pour les investisseurs, on réduirait les incitations à se comporter en passager clandestin.

Option 4: Reviving Subscriptions – prior to the 1970s, the CRAs revenue came from a levy on the investors who used their ratings. At this time, the CRAs were not 'tied up in the system' like they are today [28]. This would reduce the incentives and free rider problems mentioned above. The main problem with this proposal is that it is linked to the public good aspect as described by Portes who notes that there will be free rider problems and payment by the user of the information will be either suboptimal or unenforceable, which is the reason why the CRAs stopped this practice in the 1970s.

Option 5: Providing additional information apart from ratings – This would address the accuracy problems highlighted above. This should include details such as assessment of the liquidity characteristics of the instruments and of likely volatility of its market price. In addition to this, it has been suggested that agencies provide a range of risk for each instrument rather than a point estimate [29] and develop a distinct rating scale for structured finance products [30]. The main problem with this proposal is that the agencies do not seem well equipped to do that as these kinds of risk are almost impossible to measure quantitatively. The CRAs are likely to lobby strongly against such an expansion of the depth of their work.

En fournissant des informations supplémentaires en dehors des notes, les agences de notation devraient inclure des détails tels que l'évaluation de la liquidité propre aux divers instruments et de la volatilité probable de leur prix de marché.

Option 6: Introducing explicit legal liability for negligence and malfeasance – At the moment, CRAs successfully maintain legal

27. Richard Portes, 2008.
28. Tara Perkings, 2007.
29. Richard Portes, 2008.
30. Ferguson et al, 2007.

immunity from malfeasance claims on the ground that they are only financial journalists publishing their opinions, which are protected by free speech, although, as pointed out by Portes, Moody's is much more profitable than Financial Times, suggesting that they are earning some rents (their 'reputational capital' and the regulatory license conferred by their role in the financial system [31]. Apart from the evident short-comings of the free speech argument, being able to hold them more legally accountable will be a way to ensure that they take full responsibility for their ratings, and as such, be more thorough and meticulous in the provision of these ratings. However, the main problem with this proposal is that quite simply, CRAs will be sued out of business should such legal liability be in place as every investor who makes losses on a AAA rated product will demand redress.

Comme le souligne Portes, Moody's est beaucoup plus rentable que le Financial Times.

Option 7: Separating rating from consultancy and advisory functions – This will need to go beyond Chinese walls [32] and will entail ensuring the CRAs do not engage in consultancy work and that their structured finance business is stopped. This will eliminate the conflict of interest problems mentioned above. The main problem with this proposal is that the CRAs are likely to put up great resistance to giving up a highly remunerative line of work and to accept a dramatic decrease in their revenue stream.

Option 8: Decrease Barriers of Entry – The rationale for this is that it would allow more CRAs into the market and create competition which will improve the performance of CRAs. However, the main problem with this proposals is the natural monopoly tendencies of the industry alluded to above as well as the possibility that more players will exacerbate the incentives problems and there will be more competition to gain issuers business which may be done by providing the highest rankings.

Pour séparer les activités de notations de celles de conseil, il faudra faire plus que des « murailles de Chine », il faudra prendre des mesures pour s'assurer que les agences de notation ne s'engagent pas dans des activités de conseil et qu'elles ont abandonné leur activité dans la finance structurée.

Options Analysis

Table 1 looks at the extent to which the policy problem addresses the problem category as highlighted above. Here, 'yes', 'no' and 'maybe' are used to indicate how whether or not the policy proposal addresses the problem. In this exercise, it shows that no one solution can address all the problems relating to CRAs. This means that a 'policy package' comprising key suggestions from each proposal will be needed.

The elements to be included in such a policy package should depend on the feasibility level of the implementation of that

31. Richard Portes, 2008.
32. Ibid

Table 1 : Which problem category does each policy proposal address?

PROBLEM CATEGORY → POLICY PROPOSALS ↓	**Incentives**	**Conflict of Interest**	**Accuracy**	**Pro-Cyclicality**	**Competition**
Nationalization	YES	YES	MAYBE	YES	NO
No official recognition of CRA ratings	YES	YES	NO	NO	YES
Status Quo – Voluntary Code of Conduct	NO	NO	NO	NO	NO
Reviving Subscriptions	YES	YES	NO	NO	NO
Additional Information	NO	NO	YES	YES	NO
Legal Liability	YES	MAYBE	YES	YES	NO
Separating functions	YES	YES	NO	MAYBE	NO
Decrease Barriers to Entry	NO	NO	MAYBE	YES	YES

policy. Feasibility here refers to the political, lobbying and other practical obstacles that can potentially be leveled against the proposal by key market participants. Table 2 shows the relative feasibility options of each proposal on a scale of 1 (high feasibility) to 5 (low feasibility).

L'introduction de la responsabilité légale et de la nationalisation rencontreront très probablement une forte opposition politique et de la part de groupes de pression car cela représente une menace à l'existence même des agences de notation.

Here, it can be seen that introducing legal liability and nationalization will most probably encounter the greatest political and lobbying obstacles as it threatens the very existence of CRAs. This is followed by no official recognition, reviving subscriptions and separating rating from consultancy and advisory functions. This category threatens the revenue stream of CRAs. Compared to these options, asking CRAs to provide information is less threatening and allowing more CRAs into the market even less so as the major CRAs have already established their market dominance.

Table 2 : What is the relative feasibility of each option?

FEASIBILITY (1 = high, 5= low) → POLICY PROPOSAL ↓	**1**	**2**	**3**	**4**	**5**
Nationalization					*
No recognition of CRAs ratings				*	
Status Quo - Voluntary Code of Conduct	*				
Reviving Subscriptions				*	
Additional information			*		
Legal Liability					*
Separating rating from consultancy and advisory functions				*	
Decrease Barriers to Entry		*			

Recommendations

In light of the above analysis, several recommendations can be made. These shall be based on the identification of the *core problem with the current role of CRAs in the global financial system seems to be related to dealing with innovation, in terms of the valuation of new and complex instruments*. Here, the models used by the CRAs, which fail to factor in tail events and the limited amount of information provided by CRAs, are particularly problematic. Linked to this is the fact that *the 'god like' stature of CRAs blind investors to the inherent uncertainty associated with ratings which are treated as indicators of guaranteed returns on investments instead of probabilities.* This is particularly true in the case of rating new and complex instruments as was seen in the current financial crisis.

Plusieurs recommandations peuvent être faites. Celles-ci doivent être fondées sur l'identification du problème principal en lien avec le rôle actuel des agences de notation dans le système financier global. Ce problème semble être lié au traitement de l'innovation en termes de valorisation des instruments nouveaux et complexes.

With this in mind, I would propose the following;

Nationalizing the ratings function (ratings as public goods) of CRA through the setting up of a public sector rating agency as proposed by Beetsma. Here, I would propose giving CRAs two options (1) Delegate their rating function to the public sector rating agency whilst continuing with the structured finance and consultancy arm of their business or (2) Cease their structured finance and consultancy activities and focus only on providing ratings.

Je proposerais de donner aux agences de notation deux options (1) déléguer leur fonction de notation à une agence de notation du secteur public tout en continuant leurs activités dans le domaine de la finance structurée et de leur branche dédiée au conseil (2) cesser leurs activités dans la finance structurée et dans le conseil et se concentrer uniquement sur les activités de notation.

Should the CRA choose the second option, I would propose that ratings be paid for by subscription by investors, because, although the conflict of interest problem will be addressed, the question of incentives will not. With the growth of capital markets around the world, and the need investors have of ratings to inform their decision, the problem of insufficient revenue faced by CRAs in the 1970s should not be an issue today. The only change will be that instead of making obscenely large profits, CRAs' profits will fall within the normal range of other financial services providers.

The second caveat that will come with choosing option 2 is that the CRAs' performance will be monitored by regulators to ensure the quality of ratings. Should CRAs' be seen to fall below par based on a pre-determined list of Key Performance Indicators, they will be either nationalized or have their official recognition revoked.

Si une agence de notation devait tomber en dessous d'une moyenne basée sur une liste pré-établie d'indicateurs clés de performance, elle devrait être nationalisée ou voir sa reconnaissance officielle révoquée.

In addition to this, it must be ensured that ratings be accompanied by additional information beyond point-estimates as highlighted above and that CRAs' models be shown to take into account events beyond normal distributions with different instruments having different rating scales.

Les structures de réglementation qui s'appuient sur des notes, doivent alors insister sur l'utilisation d'une note agrégée de chacun des principaux organismes accrédités pour augmenter la précision et minimiser les erreurs potentielles.

Pour éviter à l'avenir cet échec, lorsqu'il y a innovation, il doit y avoir un "gel" des notations jusqu'à six mois à compter de la date d'introduction de nouveaux produits pour lesquels aucun précédent n'est disponible. Ces produits doivent être évalués "I" comme inconnu, et toutes les informations connues sur eux devraient être fournies aux investisseurs.

Basle 2, and other regulatory structures which rely on ratings, must then insist on the use of an aggregated rating of each of the main accredited agencies to increase accuracy, minimize potential errors. Here, it must be noted that the weighting of different factors by different CRAs may vary according to a set of different conditions and variables thus making certain aspects of the each CRA's rating process essentially subjective [33]. Moreover, aggregation will also potentially mitigate the effects to the high correlation and interdependence of all the lines of defense. Ideally, each has to be independent and strong. However, strengthening the second pillar in the current environment will invariably lead to the strengthening of the third pillar as well.

Finally, to prevent this particular failure in the future, whenever innovation occurs, there must be a 'freezing' of ratings for new instruments for 6 months from the time the product is introduced onto the market. Here, it should be rated "U" as in unknown, and all known information about the product should be provided to investors. This will force investors to make their own investment decision based on their risk sensitivity levels.

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33. Amelie Champsaur. 2005.

Annex 1 : Current Regulatory Framework for CRAs (EU and US)

	U.S.	E.U.
Main regulator	SEC	Bank supervisors
Regulatory tools	No registration of CRAs, but recognition by SEC as NRSRO for regulatory purposes	No registration of CRAs, but recognition by bank regulators for regulatory purposes
IOSCO Code	SEC does not recommend adoption by CRAs of IOSCO Code, but the NRSRO recognition criteria relating to conduct of business rules seem likely to be achieved by implementing the Code.	CESR recommends adoption by the CRAs of the IOSCO Code. There is no enforcement mechanism (CESR relies on market enforcement)
Recognition criteria	- Published ratings - Market acceptance of CRAs - Conduct of business rules	- Integrity of methodologies - Credibility of ratings - Conduct of business rules
Recognition goals	Efficiency of securities markets	- Efficiency of securities market (IOSCO Code) - Adequacy of capital requirements
Ongoing supervision	Limited (SEC reserves the right to reexamine conditions on which granted NRSRO status)	Permanent (as required by the CRD)
Recognition procedure	SEC discretion, although criteria are more precise under the Proposed Rule	Bank regulators are bound by the CRD rules and further details
Civil liability	No (First Amendment protection)	Never established but possible
Securities laws	Exemption under Regulation FD	No exemption under the Market Abuse Directive
Competition	The SEC believes that more precise NRSRO designation criteria will foster competition and that competition is a means of regulating CRA performance	CESR believes that competition issues should not be taken into account in establishing CRA rules and should be left to antitrust authorities.

Source: http://www.law.harvard.edu/programs/pifs/pdfs/amelie_champasaur.pdf