

Artificially Increasing Competition in the Credit Rating Industry: The ESMA Meets an Immovable Object

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Recently, the European Securities and Markets Authority has aimed to reinvigorate its efforts to enforce the increase in competition within the credit rating industry. The Supervisory Provisions aim to explain, in precise detail, the rules and regulations for ‘Sectoral Competent Authorities’ with regards to enforcing the usage of rating agencies that have less than 10% of the European market share, particularly when an issuer issues structured-finance products that require two or more ratings. However, in this article we will look at the chances of this artificial push to increase competition actually working and see, through analysing the perspectives of market players, that the will of the regulator with regards to the credit rating industry is, unfortunately, irrelevant – only investors can affect the dominance of the ‘Big Three’ rating agencies.

Introduction

The European Union, like the United States, has sought to regulate the credit rating industry much more since the Financial Crisis, which can be seen by the implementation of the relevant sections of the Dodd-Frank Act of 2010¹ in the U.S., and the three ‘CRA Regulations’ that were adopted in 2009, 2011, and finally in 2013² in the E.U. However, for the most part, the aims of these legislative agendas have not been met. One of the most obvious aims of the agendas was to remove the largest rating agencies – Standard & Poor’s, Moody’s, and Fitch Ratings – from within the fibres of the economy, and to do this the legislation both sought to remove the regulatory reliance upon the agencies i.e. remove reference to the agencies in any regulations governing other financial sectors (like Broker-

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¹ *The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* 124 Stat. 1376.

² Regulation (EU) No 1060/2009 [2009] OJ L302/1; Regulation (EU) No 513/2011 [2011] OJ L145/30; Regulation (EU) No 462/2013 [2013] OJ L146/1. There was also a significant Directive which contributed to the direction of CRA related regulation in the EU, Directive 2013/14/EU [2013] OJ L145/1.

dealers, for example), and artificially increase competition to lessen the stranglehold that the so-called ‘Big Three’ (and particularly S&P and Moody’s) have over the marketplace. Yet, even though these provisions exist on both sides of the Atlantic Ocean, no progress has been made on this front in over a decade since the Crisis. In this article we will discuss the latest move by the European Securities and Markets Authority (ESMA), the E.U.’s chief financial regulator, to initiate the increase in competition that the legislation envisioned. In doing so we will be introduced to a number of *inherent* problems in this area, but particular attention will be paid to the concept of *position*. After analysing the proposed provisions by the ESMA, we will see that their aims still remain optional, with issuers who go against the stated aims of the regulations just having to explain why. Ultimately, we will understand that the desires ~~of~~ the regulators are just that – they are *desires*. In reality, it is the *requirements* of the investors that dictate the direction of this area of finance and, ultimately, these regulatory provisions do little to change that dynamic.

The E.U. Tries Again

The E.U.’s cumulative attempts to regulate the credit rating industry, for the first time, were supposedly very clear. The most recent piece of legislation – CRA Regulation III – makes clear its intentions, with regards to lessening the grip of the Big Three, when it mandates its agencies to ‘delete references to credit ratings for regulatory purposes from financial regulation’³, and ‘measures should be taken to encourage the use of smaller credit rating agencies [by way of] where two or more credit ratings are sought, the issuer or a related third party should consider appointing at least one credit rating agency which does not have more than 10% of the total market share’⁴. In specific relation to the issuance of structured-finance products – which were at the centre of the Crisis -, the E.U. dictates that ~~where~~ the issuer does not select a smaller agency, then this decision must be ‘documented’⁵ so that the decision can be reviewed by the relevant agencies if needs be.

³ Regulation (EU) No 462/2013 [2013] OJ L146/1 (8).

⁴ *ibid* (11).

⁵ *ibid* (Art. 8c).

Yet, anyone who has looked even remotely closely at the rating industry and its dynamics knows that the wording of the legislation is its own downfall. In order to have this sector run as one wants, the wording of any regulation must be water-tight, and reviewing the legislation above we can clearly see that it is not. Firstly, the aim that measures ‘should’ be taken is not forceful enough, which is an understatement for the declaration that should an issuer not obtain the services of a smaller agency, then all they must do is document the reason why. The obvious ‘gaps in the net’ that this wording produced has been recognised by the ESMA in its recent briefings. In its ‘Supervisory Briefing’, published on the 6th April 2017, the ESMA concede that ‘unfortunately, successful implementation of these Articles has been hindered by a lack of clarity in a number of key areas’⁶, with the report focusing upon the issues regarding which issuers precisely are captured by the requirements, and how the requirement to ‘document’ should be met. The report goes further, with regards to the issue of competition, by discussing the fact that, predictably ~~bizarrely~~, ‘while some larger CRAs believe competition within the CRA industry has increased, this view is not shared by smaller CRAs and new entrants’⁷. For the ESMA, the remedy for these issues is for the relevant ‘Sectoral Competent Authorities’ (SCAs) – i.e. the designated regulatory agencies tasked with monitoring the rating agencies in each individual member state – to converge and act as one in ‘encouraging’ compliance with this legislative agenda. Rather depressingly, the ESMA then proceeds to clarify the position within the legislation, and proceeds to repeat the very same rules as stated in the legislation i.e. the rules were clear in the first place. If an issuer issues a product that requires two or more ratings – as structured products do – then they are obliged to consider using a smaller agency, and if they do not do so then they must document why; that has not changed since the rule was enacted, but apparently needed to be spelled out. The ESMA conclude by urging SCAs to work together more to enforce these rules, but reading the tone of the report can only result in one conclusion – it is, and can only be, a fruitless endeavour. Yet, why is this the case? The rules were clear and fair, yet they were not followed. The reason lies in the concept of what this article is calling *position*.

‘Position’

⁶ European Securities and Markets Authority *Supervisory Briefing: A Common Approach to the CRA Regulation’s Provisions for Encouraging the use of Smaller CRAs* (2017).

⁷ *ibid* 5.

The tone of the ESMA's report is one of dejection; it merely repeats the rules of the statute *whilst* confirming that not everyone is paying attention. The reason for this, which alludes to a continuing problem in this sector, is that the regulators and legislators are not acting with reality in mind; they are making regulations with how they *desire* the rating agencies and their associated parties to act, rather than focusing upon how *actually* perform. This naivety, for want of a better term, is demonstrated clearly by the push to artificially promote competition in the credit rating industry. It is naïve because even a cursory glance at the literature on this subject confirms the presence of what is called a 'natural oligopoly', which means that there a number of factors that dictate that competition *is a negative* for the way the industry works, not a positive⁸. Before we continue, it is important to note that this author, along with many others, recognise that the dissolution of the stranglehold of the Big Three is what is required, but achieving that is another story entirely; operating with that aim in mind, but not considering the reality of the situation, is a fool's errand. This is because the natural oligopolistic features of the rating industryagency dictate that focusing upon the actions of the rating agencies, or the issuers, is to miss the point entirely. For example, it is has been noted that, in terms of the organisational elements of the industry, 'new entrants have high start-up costs related to acquiring the requisite staffing, analytical tools and information technology systems, and few resources with which to meet these costs'⁹, which ultimately means that the only agencies that can rate often highly complex issuances are the ones who have large resources with which to do so. However, there is a bigger issue and that is, existentially, who actually *uses* these ratings?

Rather than looking at the performance of the rating agencies, or even the issuers, this article calls for the regulators and legislators to instead focus upon the requirements and 'position' of the *users* of the ratings, and that is the investors. In the literature it is understood that investors' 'desire for consistency across investment products helps to sustain reliance on the few incumbents in the credit rating market'¹⁰, whilst others have noted that the financial markets contain 'investors with a limited capacity to assimilate and process information...

⁸ David F Tennant and Marlon R Tracey *Sovereign Debt and Credit Rating Bias* (Palgrave Macmillan 2015) 54.
⁹ *ibid.*

¹⁰ Mads Andenas and Iris H Y Chiu *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge 2013) 197.

therefore always result[ing] in an investor-driven natural oligopoly'¹¹. One can take issue with this last sentiment, because not all investors have this 'limited capacity', particularly not large 'institutional investors'. However, looking at institutional investors more closely, we can see that the natural oligopolistic sentiments strike again, because the managers of institutional investors are often constrained by their shareholders, or the equivalent, by way of 'agency' – i.e. dispersed interested persons can regulate the activities of managers by only allowing them to invest in products and securities that carry high ratings, for example, or can enforce investment strategy by using certain rating movements as 'triggers', so when an entity's rating drops below a certain point, the investment managers must divest from that particular holding¹². Ultimately, the relative ease for people to understand the supposed value of an 'AAA' rating over a 'C' rating, for example, makes it easier for investors, whether 'sophisticated' or not, to act without expending a lot of time or resources.

It is for this reason that the ESMA's focus on enforcing competition within this sector will not work. There have been other measures proposed with regards to enforcing the dissolution of the Big Three's dominance – with the enforced usage of non-profit agencies being one suggestion¹³ – but that has yet to bear any fruit either. This understanding of the rating industry as representing a 'natural oligopoly' is often, and somewhat strangely ignored or dismissed by regulators and legislators – one can only presume that this is down to the need to *be seen* as doing something effectual in this particular arena. However, it is not effectual, and in fact is particularly damaging as it wastes valuable time and resources as the Big Three continue to seep into the fabric of the modern economy. What is required now, by the ESMA and the SEC in the U.S., is *defined* and *forceful* action – the time has passed for words like 'should' to be included in legislation governing the rating industry.

Conclusion

¹¹ Ulrich G Schroeter 'Credit Ratings and Credit Rating Agencies' in Gerard Caprio *Handbook of Key Global Financial Markets, Institutions, and Infrastructure* (2013) 387.

¹² Mark Mobius *Bonds: An Introduction to the Core Concepts* (John Wiley & Sons 2012).

¹³ Daniel Cash 'The International Non-Profit Credit Rating Agency: The Viability of a Response' [2016] 37 *The Company Lawyer* 6.

Ultimately, we have seen how the ESMA has, rather politely, sought to remind industry participants of their legislative obligations, and herein lies the biggest issue of all. The misdirected focus of regulators is fermenting a culture of impudence that will soon be a standard if it is not corrected. Rather than focusing upon the wording of legislative agendas, and paying lip-service to the notion of enforcing competition in an environment where increased competition is simply not desired by any party other than those negatively affected by transgressions (the public), it is time for legislators and regulators to be firm. For far too long regulators and legislators have *suggested* the course of action for industry participants, and for far too long they have been blatantly ignored because of the lack of authority. If the ESMA wants to see an end to ~~these~~ repeated calls for obedience, then they must break from the crowd and *truly enforce* their will. It is not unimaginable to think that a regulator, with the help of legislators, could enforce the rule that anyone issuing structured finance products *must use at least* one rating agency that holds less than 10% of the market share; in no way is this unimaginable. Perhaps it is time regulators toughen up, take the expected backlash from industry participants and their lobbyists, and regulate for the good of the people they are paid to protect.