Academic year 2017/2018
International Banking and Capital Markets II

Lesson 14
Credit rating agencies (role and regulation)

Any copies must be authorised in writing by the author
riccardo.andriolo@athenaassociati.it
# INDEX

| 1. What are the Credit Rating Agencies | 3  |
| 2. The regulatory environment          | 12 |
| 3. Authorization and Registration     | 19 |
| 4. Press Release                      | 21 |
1. What are the Credit Rating Agencies

What they do?

Credit Rating Agencies are agencies that provide **opinion and reviews on the creditworthiness of an entity and on its financial instruments**.

The main Regulation (Regulation (EC) No 1060/2009 of the European Parliament and of the Council) for the CRAs define

- a **Credit Rating Agency** as a "legal person whose occupation includes the issuing of credit ratings on a professional basis," and
- a **credit rating** as "an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories".

S&P, one of the **"big 3"** of the Rating Credit Rating Agencies, defines the credit rating as "opinions about credit risk. Our ratings express our **opinion** about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time. Credit ratings can also speak to the credit quality of an individual debt issue, such as a corporate or municipal bond, and the relative likelihood that the issue may default. Credit ratings are not **absolute measure** of default probability. Since there are future events and developments that cannot be foreseen, the assignment of credit ratings is not an **exact science**. Credit ratings are not intended as **guarantees of credit quality or as exact measures of the probability** that a particular issuer or debt issue will **default"** [emphasis added]
1. What are the Credit Rating Agencies

Who are the «big 3»?

S&P Global Ratings and its predecessor organizations have been in business for more than 150 years. We are the world’s leading provider of credit ratings. We have more than 1 million credit ratings outstanding on government, corporate, financial sector and structured finance entities and securities. Our ratings are essential to driving growth, providing transparency and helping educate market participants so they can make decisions with confidence.

Moody’s

Moody’s is an essential component of the global capital markets, providing credit ratings, research, tools and analysis that contribute to transparent and integrated financial markets. Moody’s Corporation (NYSE: MCO) is the parent company of Moody’s Investors Service, which provides credit ratings and research covering debt instruments and securities, and Moody’s Analytics, which offers leading-edge software, advisory services and research for credit and economic analysis and financial risk management. The Corporation, which reported revenue of $4.2 billion in 2017, employs approximately 11,900 people worldwide and maintains a presence in 41 countries.
1. What are the Credit Rating Agencies

Who are the «big 3»?

Fitch Group is a global leader in financial information services with operations in more than 30 countries. Fitch Group is comprised of: Fitch Ratings, a global leader in credit ratings and research; Fitch Solutions, a leading provider of credit market data, analytical tools and risk services; BMI Research, an independent provider of country risk and industry analysis specializing in emerging and frontier markets; and Fitch Learning, a preeminent training and professional development firm. With dual headquarters in London and New York, Fitch Group is owned by Hearst.
1. What are the Credit Rating Agencies

How they do?

Credit Rating Agencies use rating model to assign a grade to the issuer under assessment. An example of Corporate Rating Process, S&P:
1. What are the Credit Rating Agencies

<table>
<thead>
<tr>
<th>Sovereign Ratings List</th>
<th>Moody's ratings [+*]</th>
<th>S&amp;P ratings [+*]</th>
<th>Fitch ratings [+*]</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States [+*]</td>
<td>Aaa</td>
<td>AA+</td>
<td>AAA</td>
</tr>
<tr>
<td>United Kingdom [+*]</td>
<td>Aaa2</td>
<td>AA</td>
<td>AA</td>
</tr>
<tr>
<td>Germany [+*]</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>France [+*]</td>
<td>Aaa2</td>
<td>AA</td>
<td>AA</td>
</tr>
<tr>
<td>Japan [+*]</td>
<td>A1</td>
<td>A+</td>
<td>A</td>
</tr>
<tr>
<td>Spain [+*]</td>
<td>Baa1</td>
<td>A-</td>
<td>A-</td>
</tr>
<tr>
<td>Italy [+*]</td>
<td>Baa2</td>
<td>BBB</td>
<td>BBB</td>
</tr>
</tbody>
</table>

**Italy’s ratings**

The Rating scale of the «Big 3»
1. What are the Credit Rating Agencies

Why are they relevant?
The role of Credit Rating Agencies in the financial crisis demonstrates how relevant are the CRAs for the financial system. They were blamed for helping to precipitate the crisis, by giving unduly high ratings to mortgage-backed securities (MBS) that later turned sour.

“The credit rating agency Moody’s has agreed to pay nearly $864m to settle with US federal and state authorities over its ratings of risky mortgage securities in the run-up to the 2008 financial crisis, the department of justice said on Friday. Moody’s reached the deal with the justice department, 21 states and the District of Columbia, resolving allegations that the firm contributed to the worst financial crisis since the Great Depression, the department said in a statement.” 14th January 2017, The Guardian

U.S. government slams S&P with $5 billion fraud lawsuit
“The United States said S&P inflated ratings and understated risks associated with mortgage securities, driven by a desire to gain more business from the investment banks that issued those securities. S&P committed fraud by falsely claiming its ratings were objective, the lawsuit said.” 6th February 2013, Reuters
1. What are the Credit Rating Agencies

The Role in the 2007 Crisis

“Subprime mortgages were the main cause of the financial crisis of 2007. Through the restructuring of the instruments, investment banks were able to carve-out AAA-rated securities from original-issue «Junk» loans. Collateralized debt obligations or CDOs, were among the most important and damaging of these financial innovations. CDOs were designated to concentrate the risk of a bundle of loans on one class of investors, leaving the other investors in the pool relatively protected from that risk. The idea was to prioritize claims on loan repayments by dividing the pool into senior versus junior slices, called tranches. The senior tranches had first claim on repayments. For example, if a pool were divided in two tranches, with 70% of the pool allocated to the senior tranche and 30% allocated to the junior one, the senior investors would be repaid in full as long as 70% or more of the loans in the pool performed, that is as long as the default rate on the pool remained below 30%. Even with pools composed of risky supreme loans, default rates above 30% seemed extremely unlikely, and thus senior tranches were frequently granted the highest (AAA) rating by the major credit rating agencies, Moody’s, Standard & Poor’s and Fitch. Large amounts of AAA-rated securities were thus carved out of pools of low-rated mortgages. Of course, we know now that these ratings were wrong. The senior-subordinated structure of CDOs provided far less protection to senior tranches than investors anticipated. When housing prices across the entire country began to fall in unison, defaults in all regions increased, and the hoped-for benefits from spreading the risks geographically never materialized. Why had the rating agencies so dramatically underestimated credit risk in these subprime securities? First, default probabilities had been estimated using historical data from an unrepresentative period characterized by a housing boon and an uncommonly prosperous and recession-free macroeconomy. Moreover, the ratins analysts had extrapolated historical default experience to a new sort of borrower pool—one without down payments, with exploding-payment loans, and with low- or no-documentation loans (often called liar loans). Past default experience was largely irrelevant given these profound changes in the market. Moreover, the power of cross-regional diversification to minimize risk engendered excessive optimism. Finally, agency problems became apparent. The ratings agencies were paid to provide ratings by the issuers of the securities—not to the purchasers. They faced pressure from the issuers, who could shop around for the most favorable treatment, to provide generous ratings.” Investments, Bodie, Kane Marcus, 11th edition
1. What are the Credit Rating Agencies

Consequences

The financial crisis and the responsibilities of the Credit Rating Agencies has enlightened the need of regulation the CRAs system. The EU understood the key role of the CRAs and subsequently the need of regulation.

“Credit rating agencies play an important role in global securities and banking markets, as their credit ratings are used by investors, borrowers, issuers and governments as part of making informed investment and financing decisions. Credit institutions, investment firms, insurance undertakings, assurance undertakings, reinsurance undertakings, undertakings for collective investment in transferable securities (UCITS) and institutions for occupational retirement provision may use those credit ratings as the reference for the calculation of their capital requirements for solvency purposes or for calculating risks in their investment activity. Consequently, credit ratings have a significant impact on the operation of the markets and on the trust and confidence of investors and consumers. It is essential, therefore, that credit rating activities are conducted in accordance with the principles of integrity, transparency, responsibility and good governance in order to ensure that resulting credit ratings used in the Community are independent, objective and of adequate quality” [emphasis added]

2. The regulatory environment

European System for Financial Supervision («ESFS»)

European Supervisory Authorities (ESA)
- European Bank Authority («EBA»)
- European Insurance and Occupational Pensions Authority («EIOPA»)
- European Securities and Markets Authority («ESMA»)

Macro prudential supervision
- European Systemic Risk Board («ESRB»)

European Banking Union
- SSM
- SRM
- EDIS
  - CRD and CRR
  - BRRD
  - DGSD

Focus
- CRAs

This scheme was explained in lesson no. 4.
2. The regulatory environment

ESMA has adopted a risk-based approach to its supervision. Risk-based supervision refers to:

- the use of a structured approach to identify the most serious risks at individual supervised entity or industry level;
- a targeted review by supervisors to assess how the supervised entities are managing the risks identified; and
- the use of available and proportionate measures to reduce and manage these risks.

The identification of risks and trends requires continuous monitoring of the periodic information and data provided by the CRAs and through TRs and monitoring of overall market dynamics. In addition, ESMA monitors industry-wide developments through engagement with the supervised entities and other external stakeholders.

The risk-based dimension allows ESMA to target its supervisory resources to those areas where the greatest risks have been identified, as well as to assess the impact and effectiveness of its supervisory strategy. This allows ESMA to adapt its supervisory approach to the evolving nature of the industry, for example to allow it to launch new investigations or market studies as well as to take ad hoc supervisory measures where necessary to reflect changes in market dynamics and innovations such as new entities, new products, services and delivery channels or new methodologies.

In the coming years, ESMA intends to enhance effectiveness and lasting impact of its supervisory activities at individual entities, intensify its risk-based approach to supervision, move from functional compliance-desk based approach to a business-based approach and strengthen its reputation through world leading expertise.
2. The regulatory environment

*Why regulate the Credit Rating Agencies?*

Credit ratings help investors and lenders to understand the risks associated with a particular investment or financial instrument. However, over-reliance on credit ratings may reduce incentives for investors to develop their own capacity for credit risk assessment.

In the period leading up to the financial crisis in 2008, **credit rating agencies (CRAs) failed to properly appreciate the risks in more complex financial instruments.** For instance, structured finance products backed by risky sub-prime mortgages were issued with incorrect ratings that were far too high.

During the subsequent euro area debt crisis, certain countries were faced with abrupt bond sell-offs and higher borrowing costs following a downgrade of their credit rating.

In response, the Commission made proposals to strengthen the regulatory and supervisory framework for CRAs in the EU, to restore market confidence and increase investor protection. The new EU rules were introduced in three consecutive steps.

2009  
2011  
2013
## 2. The regulatory environment

### Commission measures

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>The first set of rules, which entered into force at the end of 2009, established a <strong>regulatory framework</strong> for CRAs and introduced a regulatory oversight regime, whereby <strong>CRAs had to be registered and were supervised by national competent authorities</strong>. In addition, CRAs were required to avoid conflicts of interest, and to have sound rating methodologies and transparent rating activities.</td>
</tr>
<tr>
<td>2011</td>
<td>In 2011, these rules were amended to take into account the <strong>creation of the European Securities and Markets Authority (ESMA)</strong>, which supervised CRAs registered in the EU</td>
</tr>
<tr>
<td>2013</td>
<td>A further amendment was made in 2013 to reinforce the rules and address weaknesses related to sovereign debt credit ratings</td>
</tr>
</tbody>
</table>
2. The regulatory environment

Commission measures

The current regulatory framework → The latest legislative package on CRAs consists of a regulation (Regulation No 462/2013) and a directive (Directive 2013/14/EU). These laws seek to:

✓ reduce over-reliance on credit ratings
✓ increase transparency regarding the issuing of sovereign debt ratings
✓ improve the quality of the rating process and make credit rating agencies more accountable for their actions
✓ reduce conflicts of interest and encourage a greater number of actors to operate in the credit rating market

According to the Financial Times, Italy’s auditor general (“Corte dei conti”), believes that S&P may have acted illegally and could be sued for €234bn (£194bn). The paper cites a letter from the Corte dei conti notifying S&P that it is considering legal action: “S&P never in its ratings pointed out Italy’s history, art or landscape which, as universally recognized, are the basis of its economic strength.”

https://www.theguardian.com/business/2014/feb/05/italy-standard-poors-value-history-art-culture
2. The regulatory environment

*Key elements of the EU Regulation on CRAs*

According to the EU rules, when the agencies communicate credit ratings or rating prospects to the European Securities and Markets Authority (ESMA), the agencies themselves classify them according to the following *types of ratings*:

a) **corporate** rating;
b) rating of **structured financial instruments**;
c) **sovereign** ratings and **public finance** ratings;
d) **other financial instruments** (Article 3 EU Commission Delegated Regulation No. 2015/2 of 30 September 2014).

Moreover, the Regulation sets the *regulatory technical standards for the presentation of information* that the credit rating agencies should make available to the European Securities and Markets Authority, and the *regulatory technical standards on the periodic notifications of fees applied* by credit rating agencies for the purpose of continuous supervision by the European Securities and Markets Authority.

To improve the competitiveness of the market, Article 8d of the CRA Regulation requires issuers or related third parties, who intend to appoint two or more CRAs to rate an issuance or entity, to consider appointing at least one CRA with no more than 10% of the total market share in the EU.
2. The regulatory environment

Concentration of the market

The Table below provides a list of all CRAs registered in the EU in accordance with the CRA Regulation. For each CRA listed, ESMA provides the applicable total market share.

The data are from the Report on CRA Market Share Calculation, 20th December 2017.
3. Authorisation and Registration

The credit rating agencies have to be **registered or certified** in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009.

The list of registered CRAs is published by ESMA in accordance with Article 18(3) of the Credit Rating Agencies Regulation and is updated within five working days of adoption of a registration or certification decision.

The European Commission republishes the list in the Official Journal of the European Union within 30 days of any update. There may therefore be differences between the list published by ESMA and the list available in the Official Journal during that period.

The list provides the names of CRA and their status (Registered, Confirmed and De-registered)

There is only one de-registered CRA:
In 29th March 2017, Feri EuroRating Services AG has been de-registered because of it was acquired by Scope KGaA, the parent company of Scope Ratings (a registered CRA), on 1 August 2016. Subsequently, all of Feri EuroRating’s corporate and sovereign credit rating-related activities, and its internal control functions, were transferred to Scope Ratings.
3. Authorisation and Registration

Italy authorised CRAs

<table>
<thead>
<tr>
<th>Name of CRA</th>
<th>Country of residence</th>
<th>Status</th>
<th>Effective Date</th>
<th>Legal Entity Identifier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fitch Italia S.p.A.</td>
<td>Italy</td>
<td>Registered</td>
<td>31 October 2011</td>
<td>213800POJ9Q5CHL3KR31</td>
</tr>
<tr>
<td>Moody’s Italy S.r.l.</td>
<td>Italy</td>
<td>Registered</td>
<td>31 October 2011</td>
<td>549300GMXJ4QK7OU68</td>
</tr>
<tr>
<td>S&amp;P Global Ratings Italy S.R.L.</td>
<td>Italy</td>
<td>Registered</td>
<td>31 October 2011</td>
<td>54930000NMOJ7ZBUQ063</td>
</tr>
<tr>
<td>CRIF Ratings S.r.l.</td>
<td>Italy</td>
<td>Registered</td>
<td>22 December 2011</td>
<td>8156001AB6A1D740F237</td>
</tr>
<tr>
<td>Cerved Rating Agency S.p.A. (previously CRIF S.p.a.)</td>
<td>Italy</td>
<td>Registered</td>
<td>20 December 2012</td>
<td>8156004AB6C992A99368</td>
</tr>
<tr>
<td>Dagong Europe Credit Rating Srl (Dagong Europe)</td>
<td>Italy</td>
<td>Registered</td>
<td>13 June 2013</td>
<td>815600BF4FF53B7C6311</td>
</tr>
<tr>
<td>modeFinance S.r.l.</td>
<td>Italy</td>
<td>Registered</td>
<td>10 July 2015</td>
<td>815600B85A94A0122614</td>
</tr>
</tbody>
</table>
4. Press Release

Italy is threatening to sue the credit ratings agency Standard & Poor's for failing to value its historical and cultural treasures. The country that bequeathed the world Dante, da Vinci and an enviable vision of La Dolce Vita, thinks financial analysts would not have issued a damaging credit downgrade against Italy if they had paid more attention to its cultural wealth than its spiralling budget deficit. According to the Financial Times, Italy's auditor general, the corte dei conti, believes that S&P may have acted illegally and could be sued for €234bn (£194bn). The paper cites a letter from the corte dei conti notifying S&P that it is considering legal action: "S&P never in its ratings pointed out Italy's history, art or landscape which, as universally recognised, are the basis of its economic strength." S&P has described the claims as "frivolous and without merit". The investigation extends to S&P's rivals Moody's and Fitch, with further details expected to be revealed by the corte dei conti on 18 February. Moody's dismissed the allegations, while a spokesman for Fitch said: "As we understand the prosecutor's concerns, we believe Fitch at all times acted appropriately and in full compliance with the law." The prosecutor’s investigation is likely to focus on S&P’s decision to cut Italy's credit rating two notches to BBB+, as part of a sweep of eurozone downgrades in January 2012. Mario Monti, at the time newly installed as Italy's technocratic prime minister, described the downgrade as "a further problem as it makes certain investments impossible". The downgrade confirmed that the epicentre of the financial storm had moved to Italy, and the cost of Italian borrowing soared in the weeks after S&P's decision. S&P said the downgrades were necessary because European leaders were failing to deal with their debt problems, while eurozone leaders accused the agency of not understanding the measures they had agreed to calm the crisis. The latest Italian case may be the first time the powerful ratings agencies have been accused of culturally illiteracy, but they already faced charges of poor maths and dismal economic forecasting. When the US saw its creditworthiness downgraded in 2012, the then Treasury secretary Tim Geithner accused the agencies of "a stunning lack of knowledge about basic US fiscal maths". The US government is pursuing a £5m lawsuit against S&P, accusing the agency of defrauding investors by pumping up the ratings of mortgage securities to win more business from large investment banks. The ratings agencies also stand accused of failing to see the financial storm coming. In 2009 Moody's issued a report titled Investor Fears over Greek Government Liquidity Misplaced – just six months before Athens was forced to seek a bailout.
References


https://www.esma.europa.eu/supervision/credit-rating-agencies/risk


https://countryeconomy.com/ratings