Beyond the New Economic Sociology:

The Role of Embedded Networks in Post-Neoliberal Economic Culture

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The power of Credit Rating Agencies (CRAs) over the fortunes of economic actors was brought into sharp question by the recent financial crisis. The natural response of governments firstly to apportion blame and secondly to regulate brought the role of CRAs in the financial sector into focus.

As "gatekeepers" of the markets, the reputational capital of CRAs is built on trust, notions of which have suffered setbacks in the wake of the crisis. In a classical economic view of the world, homo economicus maximizes his utility without recourse to deceit, fraud or malfeasance. In referring more closely to reality and acknowledging the existence of such practices, economic sociology not only sees financial markets as tangential representations of social interaction, but would seek to offer two explanations as to why greater levels of malfeasance are not seen. The undersocialized account would refer to institutional barriers to such while the oversocialized account would point to the internalization of social norms such as trust. Embedded economic networks, by contrast, stresses the role of concrete personal relations or networks that regulate action. Yet in an increasingly globalized, anonymized, atomized market, how useful is the embedded network analysis in providing an answer to the regulatory reforms that governments around the world have declared aphoristically necessary?

Using regulatory reform of the CRA market as an example, the paper argues that a new form of 'depersonalized' network that combines both under- and over-socialized accounts of economic interaction and which embraces government intervention as a necessary corollary to the effect of free market policies on community cohesion, and consequently on embedded networks, must be recognized.

Table of Contents

Introduction

In 1996, Thomas L. Friedman quipped in an interview that there were only two superpowers in the world; the United States and Moody's.[1] He went on to state that it wasn't clear which was more powerful. Eight years later, following the collapse of Enron, Senator Joseph Lieberman stated to a Senate Committee that "The credit rating agencies were dismally lax in their coverage of Enron".[2] Not only did they not read Enron's proxy statement, but did not even know what information it might contain. The apocryphal wishes of an analyst at an agency that "we're all wealthy and retired by the time this house of cards falters" highlights the worst of the practices that played a role in the financial crisis.[3] The power of Credit Rating Agencies (CRAs) to determine the fate of economic actors was sharply demonstrated by more recent public pondering over whether to downgrade Spain's credit rating.[4] Moody's analyst Kathrin MuehlBronner's declaration that Spain could see a further downgrading of its credit rating sent shivers through the Eurozone markets, even though no downgrade was imminent.[5] Again, following a Standard & Poor's reclassification of Greek bonds as "junk" a frenzy of meetings consumed European heads of state and the International Monetary Fund with the sole aim of hammering out a rescue package for Greece.[6] While the information leading to S&P's conclusion had been available for months, the statement had the effect of panicking the markets into action. Yet the bonds were no more junk in the hour after the announcement than they had been in the hour before before - or in the preceding months in fact. The power that a handful of companies have over nation states suggests that their opinions command so much respect that the Credit Ratings Agencies do more than comment on financial reality - they create it. So great are the stores set by pronouncements of the big three CRAs that such ratings can be self-fulfilling prophecies.

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1 Thomas L. Friedman, interview, NewsHour with Jim Lehrer, PBS, February 13, 1996. Cited in Partnoy, "How and Why Credit Rating Agencies are not Like Other Gatekeepers", San Diego Legal Studies Paper, No.07-46, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257, at 65

2 Senate Committee on Governmental Affairs, press release, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs" (October 8, 2002). Cited in Partnoy, "How and Why Credit Rating Agencies are not Like Other Gatekeepers", San Diego Legal Studies Paper, No.07-46, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257, at 68.

3 Hunt, John Patrick, "Credit Rating Agencies and the 'Worldwide Credit Crisis'; the Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement", Columbia Business Law Review, oVl.2009, No.1, at 49

4 Moody's had put Spain's rating on review on December 15th 2010 after lowering it form AA1 to Aaa in September that year. This came after Fitch termed the outlook for Spain 'negative' and Standard and Poor's had downgraded the rating from AAA to AA in January 2009.

5 The downgrade that eventually materialized on 10th March 2011 to Aa2 by Moody's saw Spain's cost of borrowing soar. There were also tangential dips in the Euro and rises in German bonds.

6 Downgrade of April 2010

This may or may not be desirable - the consumerization of nation states in the credit sector is not for this discussion. CRAs have received increased attention as a result of several major lapses of judgment including the cases of Enron, WorldCom and Armlet, to name only a few, in which falling bond and stock prices gave clues as to the troubles faced by the companies significantly prior to the downgrading of ratings by the agencies. The problems discussed here, however, arose when the marketization of the CRA sector became such that conflicts of interest, sheer bad management and lack of due diligence culminated in the financial crisis of 2007-2009 and severely damaged the trust placed in the "gatekeepers" of the markets.[7] Partnoy has gone further and distinguished CRAs from traditional market 'gatekeepers', designating them 'gateopeners' to the markets, and pointing out that by engaging in ratings of securitized financial products they are performing a task unlike any other gatekeeper. He remarks that no other gatekeeper "has created a dysfunctional multi-trillion dollar market, built on its own errors and limitations".[8]

Several factors both pertaining to the business of the CRAs and the shifting nature of the market transpired to alter the role of the agencies in the marketization of financial products. While the actions of CRAs were not sufficient causation for the crisis, they were an essential contributing factor, and it no surprise that a large portion of blame for the economic crisis has fallen at their doors. Of more surprise is the limited role that CRAs claim to play in the facilitation of market interactions. As ratings agencies they assess and rate the likelihood that certain debts will not be serviced by the issuer, providing a source of information that classical economic theory tells us reduces transaction costs. While not legally sanctioned, most investors require at least two (sometimes three) separate ratings for substantial investments. Yet the CRAs, facing claims that AAA rated bonds that became junk bonds - and worse - overnight due to lack of due diligence, have been at pains to point out that ratings are mere 'opinions' and are the subject of free speech owing to the companies' legal personality.[9] Each of the "big three" CRAs - Standard & Poor's, Moody's, and Fitch - all state categorically that their ratings should not be used to determine investment wisdom, or even debt volatility. How then, do these three companies hold sufficient sway in the

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[7] Some commentators put the start of the crisis as far back as 2000, prior to which market deregulations allowed CRAs to reap massive profits assigning ratings. The previous year had also seen the repeal of the Glass-Steagall Act which had separated the speculative branches of banks from their deposit-taking functions. This not only increased the potential gains from speculation massively but exponentially increased the risk and uncertainty. John Coffee Jr. coined the term "gatekeepers" of the markets.

[8] Partnoy, "How and Why Credit Rating Agencies are not Like Other Gatekeepers", San Diego Legal Studies Paper, No.07-46, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257, at 80.

[9] This view has been sanctioned by several lower courts in the United States, notably in the Jefferson County case (see below). Partnoy argues that this view is erroneous.

market place that they can not only determine the fate of private economic actors but can also bring down governments and entire nation states?[10]

Reputational capital has been argued by many commentators to be not only the main value traded by CRAs but the principal means of regulation among the agencies. Reputational capital is such a notable force within the market that it has been used to identify and explain perfect market function in the credit ratings sector. In short, the agencies have built up a reputation for accurate ratings over many years, and will seek to maintain this as a priority. It is this that secures future business, and agencies found to be issuing low quality ratings will eventually be pushed out of the market. This view is highly pervasive and the reforms currently taking place as a response to the financial crisis all embed the concept within regulatory mechanisms. Competition, as a corollary to reputational capital is bolstered with transparency and ex post analyses of the accuracy of ratings. In 2006, efforts were made to introduce competition into the credit ratings market. The Credit Rating Reform Act of 2006, ironically finalized only weeks before the crisis started to unravel, amended the Securities and Exchange Act of 1934 in the United States and introduced the category of Nationally Recognized Statistical Rating Organization (NRSRO), under which recognition was necessary for the assignment of ratings regarding certain products and informing certain rating-based regulation. Recognition was open to any agency with a credible client base, therefore opening up the market to new entrants and introducing competition into the marketplace. Yet the duopoly of S&P's and Moody's and the overriding hegemony of the 'big three' in the market (with the addition of Fitch, Inc.) remains unchallenged. This leads us to the conclusion that the CRA market does not function in a manner in which classical economics can explain. For historical, functional and institutional reasons, the credit ratings market has embodied a form that is seemingly impervious to economic, and legal challenge. Moreover, the reputational model upon which regulators have staked so much can only be relied on to a limited extent, and cannot be used to regulate CRA practices in the rating of new financial products. Section XX of the paper will explore this further.

If basic economics struggles to explain the position and role of CRAs in the market place, economic sociology has similar problems. The role of reputational capital and trust is crucial to an understanding of the function of CRAs, however this is reliant on theories of networks and relations. Yet over the past few decades the free market policies that have inspired much Western political philosophy has seen the prioritization of the economic over the social. Coupled with the

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[10] The example of Iceland's struggles with CRAs is illuminative here.

effects of globalization and the increasing internationalization of markets and market relations, it no longer seems realistic to assume any 'networks' or developed relations between the atomized individuals who trade in public, private and sovereign debt on the world's markets daily. The fleeting dyadic relations that do exist are anonymized to such an extent that basing a theory of social intercourse on such may appear optimistic. CRAs, however, do have the opportunity to develop such networks, as there are only a handful of market participants. However, the sheer volume of securitized products developed over the past decade, and the effects of a global marketplace means that even in these situations it is difficult for embedded networks to be realistically envisaged. While the disintegration of one network need not entail the breakdown of the entire chain, when coupled with conflicts of interest, the fact that there is no network structure to fall back on places the market in dangerous territory.

The one market factor that does play a role in the oversight of the CRAs is reputational capital, or in economic sociology terms - trust. Granovetter dedicated part of his seminal essay "Economic Action and Social Structure: The Problem of Embeddedness" to the discussion of fraud, deceit and malfeasance which are notable for their absence from classical theories of the behavior of *homo economicus*.[11] The claim that embedded networks can work to inhibit the practice of malfeasance works in a comparable, although not identical, way to economic theories of reputational capital, and these will be discussed further in the section on trust.[12] If accurate, however, the financial crisis should have been moderated to a large extent by these theories. Studies of CRA behavior in times of economic and financial crises, however, lead us to conclude that reputational capital and the trust found in networks does not yield the complete picture and is not sufficient to be relied upon as a regulatory mechanism.

The natural response of governments concerned primarily with self-preservation is to firstly apportion blame and then to regulate. CRAs, as a recipient of substantial amounts of blame, have unsurprisingly been the target of equal amounts of threatened regulatory reforms. Both the United States and the European Union have drafted proposals, regulations and acts that impose stricter regulation on the CRAs and increased oversight. Yet while this year will see some of these reforms enter into force, the surprising point is how little the reforms seek to restructure the industry. This

[11] Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness", in Granovetter and Swedberg, "The Sociology of Economic Life", Boulder, Oxford, Westview Press, 1992

[12] Ideas of trust and 'general morality' mirror inquiries into the reputation mechanism in economic literature.

may be for two reasons. The preferable - but less likely - option is a reappraisal of the market mechanisms and ideology that have informed the past two decades of globalization and a questioning of whether these provide the answers to a way out of the mess they created. The more likely answer to the tentative nature of the regulatory reforms comes down to the power held by the CRAs over the fate of nation states, exemplified on a corporate scale by the Hannover Re incident.[13] The financial crisis has left many national economies financially dependent on issuing debt to global markets, and the success of this is highly dependent on a suitable credit rating provided by the very companies responsible not only for the worst of the crisis, but for the struggling health of the nations hit hardest.

What's more, the reforms fail to question the economic orthodoxy pervading market structures and functions. Classical and neoclassical economic theory still informs much market regulation, and hence social regulation. The development of a market *society* in nineteenth-century England, in contrast to the market *economies* in the rest of Europe, while witnessing an encumbering of the markets in a flirtation with social democracy in the inter-war period and the decades the followed, saw the rebirth of neoliberal, *laissez-faire* economics in Thatcherite policies. The infatuation with this throughout the Anglo-Saxon world, in particular through US cultural, political and economic hegemony has seen the continuing embedding of society in the economy. The massive deregulations that occurred in the 1980s, 90s and into the twenty-first century marked efforts to un-encumber the markets and release the true economic potential of free markets and free trade, bringing with it the social upheaval and community disenfranchisement consequent on free market reforms.[14] Re-regulation of the CRAs both continues this movement and conversely offers hope that regulation - the interference of government in the pursuit of social values and stability - although may be not in that order - may characterize a retreat from free market ideology that has plagued international markets and development.

The impact of regulation and deregulation appeal to similar means to achieve opposed ends. Regulation sees a prioritization of the social over the economic, while deregulation aims for the opposite. Each use, abuse and are reliant on social and economic networks for the attainment of

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[13] The German insurer, Hannover Re, was offered free ratings by Moody's. Upon the former's refusal, Moody's duly rated the company and retrospectively invoiced it for the trouble. Moody's continued rating the insurer, but upon repeated refusal of its services by Hannover Re, Moody's assigned "junk bond" status to the insurer's debt, seeing Hannover Re lose $175 million in value in a matter of hours.

[14] See further John Gray, "False Dawn, The Delusions of a Global Capitalism", Granta 2009. See also John Gray, "Straw Dogs: Thoughts on Humans and Other Animals", Granta, 2002, for equally strident views on humankind's notions of progress and the cyclical dawning of history.

their goals, and each endanger those very networks in different ways. In the case of regulation, networks of embedded trust within society that lubricate the course of economic transactions are subordinated to the new regulations which perform the same function. With deregulation, in theory, there should be greater social space for embedded networks to flourish, and indeed this might be the case in the short run, however the free market policies at which deregulation usually aims invariably witness a withering of social cohesion and interaction upon which networks are founded and operate.

The paper will then ask how a sociological approach can help understand the role of regulation in financial markets with reference to current regulatory reform ongoing in the area. An undersocialized account would examine the institutions that have evolved to ensure that malfeasance in the sector is kept to a minimum. This would not only look at legal and political institutions such as the National Recognized Statistical Rating Organization (NRSRO) regulations introduced in 2006, but social and historical institutions that support the effective conduct of the agencies. An over-socialized view would see trust as the only form that operates to moderate malfeasance, internalized in each actor to such a degree that compliance is no longer a burden. It mitigates the importance of laws and institutions that support it. By contrast, reputational capital that is commonly seen as regulating CRA conduct spans both views as it is trust based, but also reliant on networks of actors, here understood as a social phenomenon. The classical embeddedness argument stresses the role of concrete personal relations and reputational capital or the idea of trust developed over many years is indeed present within these concrete relations. But this cannot explain firstly the failure of CRA actions to predict the crisis and their behavior during such. Nor can these networks and notions of reputational capital be relied upon as a regulatory mechanism.

Regulation introduced into the CRA market must neither result in a under- or oversocialized approach to regulation. Moreover, such regulation must seek to achieve the right balance between economic and social interests. The atomization of the marketplace as a result of globalization and free market policies reduces possible reliance on theories of networks as regulatory mechanisms within society that can moderate malfeasance. Another model is needed, one that can use the remnants of such networks, and maybe even foster their regrowth, but one which uses the organizational abilities of the central state to disseminate the information that should circulate with embedded networks. A similar structure exists in other areas, and the US Treasury Black List is one example of state regulation and dissemination of information that serves a similar purpose to embedded economic networks.[15] Information on the CRAs and debts generally in the marketplace must be provided by central institutions in such a way that the information is not subject to the political winds of the administration. A central depository for data on CRAs is being developed in the EU, but it is submitted that this step should be taken elsewhere. A wiki-like institution where information can be deposited, sorted, analyzed and accessed by those engaging in the financial debt markets, consolidated in one place, is necessary for the restructuring of such 'depersonalized' networks in the twenty-first century. Then again, technology has not only given us the wiki, but also access to vast sources of information which may, eventually, reduce the omnipresence of the CRA in future markets.

[15] While it is worth noting the US Treasury Blacklist, this does function in a different way. It is not proposed that criminal sanctions should form part of the regulation of CRAs.

The Financial System

The Basel Committee on Banking Supervision estimates that there are 130 CRAs in operation globally, with about 30 of them playing a prominent role in the G10 countries.[16] Some agencies provide ratings, either solicited or unsolicited, on a limited number of issuers, while others use statistical models to assign ratings to all issuers in a certain marketplace. The ratings themselves can either relate to fixed-income securities and structured finance products, or to the issuers themselves such as corporations, municipalities and governments. CRAs also provide other services to the market, including rating assessment services, risk management and consulting services. CRAs provide an assessment of the creditworthiness of the issuers and also of the debt instrument which gives an indication of the probability of default or of a delay in payment. As is commonly stressed by the CRAs, ratings do not quantify the wisdom of the investment, only the relative safety of the securities. In the case of asset-backed securities, ratings seek to iron out the information asymmetry between the parties, and therefore, according to Schwarcz, perform a similar function to securities law.[17] In other words, the rating acts as a guarantee of quality, as the CRA acts as a certifying agent by using its reputation to guarantee the quality of the security.[18]

As stated, credit rating agencies are in the business of predicting default probabilities for various kinds of debt securities and issuers. A rating therefore indicates the likelihood of repayment, and is not a discrete rating but comparative among different types of securities. Credit ratings usually mirror the long-term prospects of a debt security and do not tend to reflect short term market fluctuations, however significant information is reflected in up- or down-grades that take place. CRAs are specialized in capital market transactions and can be classified as information intermediaries.[19] Ratings also serve as a regulatory tool in financial market oversight. Banks and investment funds use these rating as yardsticks for calculating risk. It should be noted however that

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16 White, "The Credit Rating Industry: An Industrial Organization Analysis", in R.M. Levich, G. Majnoni & C. Reinhart, Eds., *Ratings, Rating Agencies and the Global Financial System*, Boston, Kluwer Academic Publishers, 2002, 44-46; S.L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", [2002] *U. Ill. L. Rev.* 1, 7. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 13.

17 S.L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", [2002] *U. Ill. L. Rev.* 1, 10. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 15.

18 F. Partnoy, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the CreditRating Agencies", (1999) 77 *Wash. U. Law Quart.* 619, at 632.

19 Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation", available at http://ssrn.com/abstract=991821

CRAs are not the only institutions to whom information concerning the issuer or debt is available, and the point should be made that good information provision can negate over-reliance on credit ratings.

The story of financial market regulation with respect to CRAs shows peaks and troughs of action that correspond closely to growth and crashes. Ratings can inform regulatory functions, and these in turn can be divided into three main functions; disclosure requirements, investment restrictions, and capital requirements. In short these aim to regulate more closely the riskier investments while freeing up fairly safe ones from the burden of red tape, in the same process avoiding market instability. Ratings first came to inform substantive regulations in the United States in the 1930s as part of general safety-and-soundness regulations that responded to the economic crash. The aim of regulations introduced at the time was to protect liability holders and ensure general market stability. Personal credit ratings were introduced into substantive regulation in the 1970s after another economic crisis, at which time the Securities and Exchange Commission (SEC) also introduced a standard definition for the agencies, terming them 'National Recognized Statistical Rating Organizations' (NRSROs) which then became the only bodies that could produce ratings compliant with legislative requirements. Following the later Basel II summit and the initial publication in 2004, the importance of private credit ratings in regulatory regimes was increased, notably in the area of capital requirements for commercial loans. Internal or external credit ratings were acceptable for these purposes, although due to cost, infrastructure and finance restrictions, only large banks were able to carry out their own internal credit ratings, leading to increasing use of, and reliance on, CRAs.[20] Rating-based regulation has seen a growth over the past decades, primarily at the hands of state legislation. While reliance on credit ratings has grown, the tight controls over the CRAs has seen a reduction in the pool of market competitors to fulfill this legal requirement.

The first issues of sovereign states in the 1960s and 70s were rated by the two predominant US agencies, while the 1980s and 1990s saw a rapid expansion of the business of CRAs due to the globalization and internationalization of global finance markets including domestic bonds in Europe and Japan. Dittrich identifies five factors that have driven the growth of the ratings industry over

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[20] The Basel II Capital Accords were implemented in Europe in the form of the Capital Requirements Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC, was published in the Official Journal on 30 June 2006. See http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

recent years.[21] Structural changes in the markets, a rapid increase in market participants, and a resulting increase in levels of anonymity have been mirrored by increasing numbers and complexity of financial products themselves. Secondly, credit supply has shifted on the whole from banks to capital markets, while securitization has aided in the development of increasingly complex products. Thirdly, sovereign states have increasingly turned to international capital markets for finance, leading to a situation in which local companies are scrutinized on their own - and their government's - credit rating. Fourth, American reliance on credit ratings has come to inform globalized notions of international finance, and finally the growth of ratings-based regulation in the US and consequently in most other markets, has sealed the fate of the CRA as one of the most important facilitators of debt transactions. Not only has the number of available debt securities on the market increased exponentially, but their complexity has followed suit, increasing the informational asymmetries between trading partners who have no choice but to rely on the CRAs for reliable assessments of the debt.

Prior to the 1970s investors were charged for ratings publications on a subscription basis. Owing to the increase in products this was deemed unsustainable and issuers became liable for the cost of their ratings by all CRAs in the 1970s. Partnoy argues that it makes economic sense to charge issuers rather than investors for the rating as the cost is proportionally spread among investors according to the percentage they hold owing to a reduction in the yield of the debt security.[22] Since the 1970s the fortunes of CRAs has increased exponentially with eye-watering profits and equally high operating margins.[23] Resulting conflicts of interest arising from this will be discussed further.

US Regulatory Landscape

In the US, the effective duopoly of S&P and Moody's, along with three smaller CRAs, formed the entirety of NRSROs until the 2006 Credit Rating Agency Reform Act which allowed any CRA with

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21 Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation", available at http://ssrn.com/abstract=991821, at 18.

22 Partnoy, [1999] at 654, cited in Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation", available at http://ssrn.com/abstract=991821 at 19.

23 In 2003, a rating from Moody's, depending on the size of the debt, could cost between $33, 000 and $275, 000. In 2005 credit rating revenues of $1.590 billion at Moody's generated operating profits of $935 million - an operating margin of 58 per cent. By contrast, Microsoft's operating margin was 37 per cent for the same year. Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation", available at http://ssrn.com/abstract=991821, at 20.

a credible client base to apply to register as a NRSRO.[24] This became effective in 2008.[25] The NRSRO designation has been in operation since 1975 and agencies without Securities and Exchange Commission (SEC) recognition are thus effectively barred from a large part of the market. There has been a distinct lack of definition offered for the NRSRO, though in a no-action letter process the SEC developed a list of criteria that it considers relevant to NRSRO designation. Among this list was the requirement that the agency be "nationally recognized by the predominant users of ratings in the United States as an issuer of reliable and credible ratings".[26] This has led to accusations of a Catch-22 scenario in which "an agency has to be nationally recognized to be an NRSRO, but has to be an NRSRO to be nationally recognized".[27] Following the accounting scandals in the early 2000s the Credit Rating Agency Reform Act 2006 was adopted which aimed to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating industry".[28] The Act sought to create an objective registration framework for market participants to the credit rating industry and in 2007 the SEC adopted rules that govern the registration of CRAs.[29] These impose disclosure and record-keeping obligations and prohibit several types of conflicts of interest. However, the SEC does not have substantive or procedural review over the work of the CRAs.

EU Regulatory Landscape

CRAs have remained largely unregulated in the EU with the exception of three more general market directives.**[30]** The Committee of European Securities Regulators (CESR), in a study following the fall of Enron, concluded that regulation of the CRAs was not necessary, preferring instead to rely on

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[24] The necessity of a credible client base poses questions as to how this is to be acquired by a non-registered agency.

[25] Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation", available at http://ssrn.com/abstract=991821, at 17.

[26] U.S., Securities and Exchange Commission, *Report on the Role and Function of Credit Rating* Agencies in the operation of the Securities Markets, 2003, p. 9. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 18

[27] C.A. Hill, "Regulating the Rating Agencies", (2004) 82 *Wash. U. L. Quart.* 43, 55. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 18

[28] *Credit Rating Agency Reform Act of 2006*, P.L. 109-291, s. 15E.

[29] See Securities and Exchange Commission, *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations,* Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007).

[30] See the *Market Abuse Directive* (MAD), Directive 2003/125/EC, the *Capital Requirements* Directive (CRD), 2006/48/EC, and the *Markets in Financial Instruments Directive* (MiFID), 2004/39/EC. See European Securities Markets Expert Group, *Role of Credit Rating Agencies*, Report to the European Commission, 2008, p. 7-9

codes of self-regulation.[31] The CESR was further tasked with investigating compliance with this code of self-regulating and reporting annually on it. After the first report which stated that the code was complied with the Commission found the case for regulation largely unproven.[32]

Regulation and further studies and proposals following the financial crisis are set out and discussed later.

Operation of the Markets and The Role of the CRAs

In order to understand why the CRAs came under so much scrutiny following the crisis it is necessary to understand, briefly, the type and level of market activity they were trying to create, facilitate and regulate. The characteristics of structured finance products made investors particularly reliant on CRAs for information about the debts. Securitization has been one of the most important developments in capital markets in recent years, leading to a massive increase in traded asset-backed securities to $2, 480 billion in 2008 in the US alone.[33]

The process of securitization involves the identification by the issuer (a corporation) of assets against which revenue can be generated. By means of a sale these assets are transferred to a special purpose vehicle (SPV) which shields the assets from risks relating to the corporation. To pay for the assets the SPV issues debt-like securities in the capital markets, the cash flows generated by which are used to make monthly or principal payments to the investors holding the securities. As such, investors are more concerned with the revenue generated by the securities than with the overall financial condition of the issuer. In the case of the recent subprime crisis there were two main types of securities issued; residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO).[34] In the case of RMBS, the SPV issues securities the payments from which derive from the mortgage loans it owns. In the case of CDO, the securities are backed by mortgage

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[31] Committee of European Securities Regulators, (CESR's) Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies, March 2005.

[32] Communication From the Commission on Credit Rating Agencies, Official Journal of the European Union, 2006/C 59/02, 59/5

[33] According to the Securities Industry Financial Markets Association. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road Toward Accountability", Capital Markets Institute, Toronto, 2009, available at http://ssrn.com/abstract=1456708

[34] Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708,

loans and other income-generating assets. While the growth and complexity of these instruments have increased substantially over several years, they have also become increasingly linked to subprime retail mortgages. The different assets are bundled, and the SPV issues different classes or "tranches" of RMBS or CDO securities according to their level of credit protection. However, of note here is that unlike traditional securitization, in the case of RMBS and CDO assets, the originator is typically different from the corporation that creates the SPV to buy the assets. In this case, an investment bank, known as an "arranger", would buy the loans and receivables from companies, package them into a pool and transfer them to a SPV that would then issue securities collateralized by those assets.[35] However, the tranches of securitized debt issued by the SPV must each have credit ratings assigned to them indicating their creditworthiness and viability of distribution. Public offerings of RMBS and CDO in the US are regulated by the SEC which imposes disclosure requirements, however most asset-backed securities are usually offered privately to qualified institutional buyers, negating the effect of disclosure requirements. In institutional private placements, however, the extent of disclosure is the lengthy negotiations that result in extensive offering memoranda.[36]

Asset-Backed Commercial Paper (ABCP) also saw the increasing inclusion of RMBS and CDO among its assets. Usually, ABCP is a type of short-term debt used by corporations to access short term supplies of cash. Commercial paper is traditionally considered low risk, and is therefore exempt from most requirements that attach to other forms of securitized debt and is usually backed by a package of assets such as credit card and trade receivables, auto and equipment leases, mortgages and other cash-flow generating assets.[37] An ABCP transaction structure is similar to that of longer-term securitized issues. Conduits are created by sponsors which can include banks, business corporations or institutions that specialize in structured finance using securitization. The conduit is an SPV that issues short term notes to investors and purchases assets with the proceeds. These can either be traditional (bank backed) assets or synthetic assets (backed by derivative

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[35] Ibid.

[36] S.L. Schwarcz, "The Alchemy of Asset Securitization", (1994) 1 *Stanford Journal of Law, Business, and Finance* 133; Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission's Staff Examinations of Select Credit Rating Agencies,* July 2008. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 7

[37] J. Chant, *The ABCP Crisis in Canada : The Implications for the Regulation of Financial Markets, Research Study Prepared for the Expert Panel on Securities Regulation*, 2008, p. 8-9; Investment Industry Regulatory Organization of Canada, *Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada*, 2008, p. 3-4. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 8.

contracts). In Canada, for example, once most consumer debt had been securitized into ABCP, conduits increasingly turned to longer-term synthetic assets such as RMBS and CDO in order to satisfy investor demand for commercial paper.[38] This trend was accentuated by the role of third-party sponsors who did not have access to bank-originated assets.[39] The conduits purchase the financial assets with funds raised by selling securities collateralized by the pool of assets. The securities issues by the conduits usually mature in 30 to 60 days, and the cash flow generated by the assets themselves is used to pay the interest on the notes and their value when redeemed. In rating the commercial paper, CRAs give an assessment of the probability of default of the conduit on its obligations in the light of its assets. Liquidity facilities are also assessed for the ABCP conduits which ensure that obligations arising from maturing notes can be honored even in times of liquidity stress. This is particularly important where conduits fund long-term assets with short-term debt.[40]

Things Start to Go Wrong

US government policy aimed to increase the number of home-owners on low income and 100 per cent mortgages and low introductory interest rates saw a massive increase in ownership. An increase in house prices saw many that had purchased remortgage their houses. However, around 2005 house prices began to fall and there was a significant rise in foreclosure rates. Investor demand for asset-backed securities had led to loosened standards in the supply of credit to subprime assets, and as foreclosure levels increased, investor uncertainty followed suit. Investors began to withdraw their investments in RMBS and CDO, sparking a liquidity crisis among institutional investors and hedge funds. Furthermore, demand for the asset-backed securities dropped, making it difficult to sell the investments and decreasing their worth even further. In addition, this was coupled by a unilateral downgrade of RMBS and CDO securities by the CRAs which further pushed down their value. As a result, institutional investors and hedge funds had to sell their investments in liquid publicly traded securities in order to satisfy lender and investor demand

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38 Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 8

39 Investment Industry Regulatory Organization of Canada, *Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada*, 2008,, p. 9. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 8.

40 In the case of Canada, there were two types of liquidity facilities available to conduits. The 'global style' agreement saw banks act as liquidity provider to conduits regardless of market disruption. The second, 'Canadian style' agreement saw liquidity provided by financial institutions (usually foreign banks) in the case of "general market disruption". This was defined as "a situation in which not a single dollar of corporate or asset-backed commercial paper can be placed on the market - at any price". It is unsurprising that this was considered a highly unlikely event. As such, both S&P and Moody's considered the scope of this too narrow and refused to rate such securities, leaving Dominion Bond Rating Service (DBRS) as the only rating agency. See Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 11.

creating a ripple effect throughout markets. This culminated in US-based banks and investment banks taking large losses in subprime-related securities, structured investment vehicles, leveraged loans and commercial lending.[41]

Holders of ABCP in Canada, for example, soon realized that the assets underlying their notes could be subprime, due to the lack of transparency and requirements of confidentiality in packaging and marketing the debt. Furthermore, the notes were often sold before, or at the same time as the assets backing them were acquired, making it virtually impossible to ascertain exactly which assets were backing which notes.[42] As banks in Canada refused to provide emergency liquidity to conduits, arguing that there had not been a general disruption in the market, the Montreal Protocol was agreed which saw a standstill and general restructuring of the commercial paper market.[43]

What Exactly do CRAs do? - The Process of Rating

Each of the CRAs goes about assigning, withdrawing or updating a rating in a similar way. In the case of asset-backed securities, the arranger will contact the agency and provide them with data on the underlying assets such as the subprime loans, the proposed structure of the SPV, etc. In this respect securitized finance is different from ratings of corporate debt where the rating is based on publicly available information. In the case of asset-back securities the only information available to the CRA on which to base the rating is that which is given by the arranger.[44] First, a loss analysis is conducted before the structure of the SPV is examined. Finally a cash flow analysis is carried out to assess the levels of principal and interest to be paid out by the SPV and whether the underlying assets are sufficient to meet the obligations arising from each tranche. The analyst then develops a rating for each tranche that is passed along to a committee which votes on the recommendation and informs the arranger of the rating. The arranger then has the final decision as to whether the rating is assigned to the debt and made public. The CRA is only paid if and when the rating is made public. If the arranger decides not make the rating public, the CRA is only paid a breakup fee.

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[41] J. Anderson, "Wall St. Banks Confront a String of Write-Downs", *N.Y. Times*, February 19, 32 2008, at C1. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 12

[42] *Metcalfe & Mansfield Alternative Investments II Corp.*, (Re) 2008 ONCA 587, par. 19. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 12.

[43] Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 13.

[44] The process followed by rating agencies to establish the ratings of RMBS and CDO has been summarized in a report by the Staff of the Securities and Exchange Commission. Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission's Staff Examinations of Select Credit Rating Agencies,* July 2008, p. 20-22.

Throughout the life of the security the CRA will review the issuer and its securities, placing them on a "watch list" if there is a risk that a rating may need altering.

The transparency of the ratings process has been one area in which CRAs have been criticized. The agencies have been criticized for not being upfront about what ratings do not assess, and for not disclosing their methodologies and the assumptions their statistical models are based on. Moreover, data regarding the historical accuracy of their models was also not made available for investors. Finally, the fact that asset-backed securities are issued under a prospectus exemption means that information about the assets remains between the issuer and the CRA and is simply not available to the investor for their own analysis. Other criticism stems from the level of resources that CRAs had to draw on. Prior to 2006-7 there was a boom in the number and complexity of products being released onto the market. While the staff levels increased at most agencies it was not in line with the increases in the market, and there have been claims that the staff levels were insufficient to provide the depth of analysis needed to issue and review the ratings.[45] This meant that ratings were often left untouched while companies ran into trouble, only being downgraded days - or hours - before bankruptcy, often when market levels were already reflecting the troubles in the share prices of the company. An SEC report also questioned the level of due diligence carried out by the CRAs in not questioning the accuracy of the loan data provided to them by arrangers.[46] Furthermore the CRAs did not require issuers to perform due diligence on their own assessments of assets, and although the CRAs did publicly declare this, there was no semblance of seeking to insure that the data fed into the statistical models was reliable.[47] Moreover, CRAs owed no legal duty to conduct due diligence.[48] Finally, the high pace of development of asset-backed securities in the market meant that CRAs had little track record of rating such complex products. The European Securities Market Experts Group indicated in a report that the wild downgrading of structured products suggests that the CRAs did not have an adequate understanding of the structured finance market to begin with.[49]

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[45] International Organization of Securities Commissions, Report on the Subprime Crisis -Final Report, May 2008, p. 25. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 23.

[46] Securities and Exchange Commission, *Summary Report of Issues Identified in the Commission's Staff Examinations of Select Credit Rating Agencies,* July 2008, p. 18; Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, 2008, p. 35. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 23.

[47] Ibid.

[48] Ratings assigned by the CRAs are "opinions", protected by law under the first amendment to the US Constitution of free speech.

[49] European Securities Markets Expert Group, Role of Credit Rating Agencies, Report to the European Commission, 2008, p. 11. Cited in Rousseau, "Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road to Accountability", Capital Markets Institute Research Paper, July 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708, at 24.

CRAs have also been criticized with respect to the existence of conflicts of interest. They act as mediators and information exchanges between issuers and investors and therefore act on behalf of both parties. The CRA charges the issuer for the rating, and the conflict of interest here is well documented.[50] The temptation to downplay risk or overlook some aspect in order to retain business is strong, given the large sums of money involved, and the tying of fees to size of investment means that CRAs are particularly vulnerable to the wishes of larger issuers. Further, note again that the CRA only gets paid if the arranger decides to make public the rating, and the retention of business is vital due to the fact that unsolicited ratings are difficult due to the fact that information about the investment is private.

The development of consulting practices by the CRAs has also created powerful conflicts of interest with agencies issuing recommendations on how to structure a product in such a way as to achieve a certain rating. As noted, while CRAs often refused to rate products which they helped design in this way, the low number of highly recognized market participants meant that issuers have little choice of CRA to approach for a rating if one helps design their security. As noted, the agency is only paid a fee on publication of the rating, and the rating assigned is only likely to be published to the market if it is likely to have the effect desired by the issuer/arranger, further encouraging the agency to inflate the rating. Moreover, the high level of reciprocal rating consequent upon the small number of agencies and reciprocal rating of products designed by close competitors leads to the conclusion that CRAs will not only understand and engage in similar practices to competitors but will be more likely to honor and rate highly products designed by them, lest future reciprocal arrangements suffer. This will be addressed further in the following discussion on the roles of reputation and trust in the market.

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[50] See T.J. Sinclair, *The New Masters of Capital*, Ithaca, Cornell University Press, 2005, p. 150-151.

Trust and the Credit Rating Agency

Credit ratings possess little informational value. Although they provide some guide to purchasers at the time of issuance, it is not clear that they provide any information beyond that contained in "price talk" associated with a fixed-income instrument - the information available prior to issuance.[51] Moreover, ratings do not help parties manage risk, and yet parties increasingly rely on ratings to facilitate transactions. Credit rating agencies are not widely respected among experienced market participants, and yet their franchise continues to grow in value. Agencies continue to argue that they are merely publishing financial opinions, and yet their opinions are far more valuable than even the most highly respected financial publishers.[52] Partnoy makes the point that in comparison to Dow Jones and Reuters, Moody's levels of market capitalization and revenues are several multiples higher, despite relatively smaller assets and employee numbers.[53] Hunt notes that credit assessment techniques of agencies, now subject to higher transparency standards, are being willingly disclosed by agencies.[54] This might suggest that they are scared of the fallout from the financial crisis, even though market values of the CRAs has not dipped significantly since the crisis. Alternatively, Hunt suggests, this is emblematic of the fact that the agencies' credit-assessment techniques are not valuable, and the disclosure of such is unlikely to impact on the function or value of the agency. Consequently, ratings derive their value from something other than their supposed high-quality.

CRAs trade on their reputation. Aside from their intermediary role as relayers of information, the primary product of CRAs is their reputation. Obtaining a rating from a CRA allows issuers to purchase a share in the agency's good reputation in order to increase their own reputation in the eyes of investors. A credit rating from one of the recognized CRAs shows that an issuer takes the notion of creditworthiness seriously and is working with a respected external partner to ensure compliance. In general, issuers with a higher credit rating will have a larger pool of subscribers, will be able to sell their debt at a lower cost, and will have lower interest rates on their repayments. A high credit rating is therefore of crucial importance. Moreover, structured debt securities are designed to receive a certain rating. As noted, many CRAs have advisory branches that assist in designing financial products in such a way as to receive a certain rating. Accordingly, many CRAs

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[51] See Partnoy (2002, pp. 65–84); see also Schwarcz (2002). Cited in Partnoy, "How and Why Credit Rating Agencies are not like other Gatekeepers", University of San Diego Legal Studies Research Paper Series, No 07-46, May 2006, at p61

[52] Ibid.

[53] Ibid, at 66.

[54] Hunt, John Patrick, "Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement", available at http://ssrn.com/abstract=1267625

refuse to rate products that they specifically designed, however the low number of market participants should ring alarm bells in this case.[55] Furthermore, the requirement that two or three ratings are obtained further emphasizes the role of duopoly or triply in which ratings agencies are not only rating products that they helped design, but which their close competitors helped design. Were one CRA to rate products significantly lower than close competitors had advised, there would not be sufficient market participants for effective market competition to arbitrate the dispute.

Several studies have been conducted that show strong correlations between CRA ratings and default rates, while others have found correlations between ratings changes and market value which indicates that not only CRAs indeed provide some reflection of accurate market information but that their publications influence market action.[56] As noted above, such is the power of a rating from one of the major three CRAs that not only market values but entire sovereign states can be the victims of self-fulfilling prophecies.

As agents in the market place, CRAs correct information asymmetries. Yet they do not provide significant amounts of new information to the market. For the most part, they assign ratings based on what is essentially public information and therefore available to any investor. In the case of privately traded securitized products the information may be private, and following the SEC's Regulation FD (Full Disclosure) this information is permitted to remain between the issuer and the CRA only. Once again, the agencies do not present new information to the market.[57]

[55] Investigations carried out by the SEC cast doubt on whether conflicts of interests that arise between consultants and raters working at the same CRA have been effectively managed. Securities and Exchange Commission, (2003) p 43, cited in Partnoy, "How and Why Credit Rating Agencies are not like other Gatekeepers", University of San Diego Legal Studies Research Paper Series, No 07-46, May 2006, at p71

[56] For a thorough overview of literature in this area see Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation", available at http://ssrn.com/abstract=991821, at 18, ibid.

[57] The market has started to receive more information following the financial crisis, relating to mechanisms, assumptions and methodologies used by the CRAs in their ratings processes. As already noted, if this information were vital to the business interests of the agencies it is unlikely that such willing disclosure would have occurred.

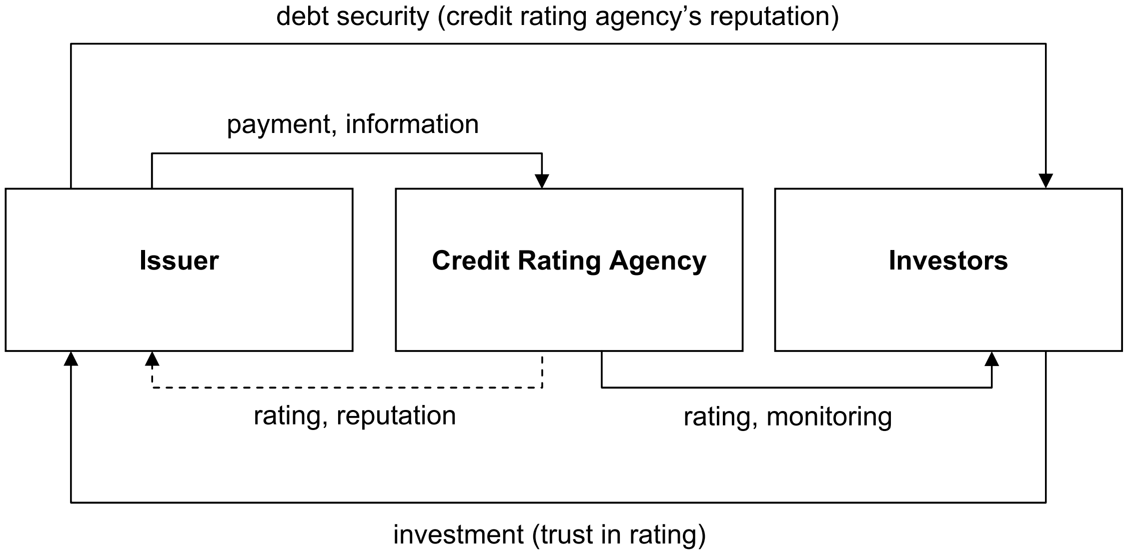

Figure 1: Information intermediation by credit rating agencies - the trust cycle (from Fabian Dittrich, "The Credit Rating Industry: Competition and Speculation")

Notions of trust

It is an assumption of classical economic theory that *Homo economicus* goes about his pursuit of rational self-interest in a purely gentlemanly manner, not resorting to fraud or deception. Such malfeasance, while difficult to reconcile with the theory, does however occur in reality. Several suggestions have been proffered to explain this phenomenon. Competition in its purest form has been explained to mitigate deceit through the function of the market, while new institutional economics adherents have argued that institutional arrangements have evolved to discourage the practice, in this case a series of elaborate explicit and implicit contracts sealing the dyad and introducing authority structures that deflect opportunism. This argument does not take into account the extent to which personal relations and institutional arrangements discourage malfeasance through the operation of obligations and expectations. Other economists have conceded that some degree of *trust* must operate since personal relations and institutional obligations could not of themselves force abstinence from fraud. Arrow suggests that societies "in their evolution have developed implicit agreements to certain kinds of regard for others, agreements which are essential to the survival of society or at least contribute greatly to the efficiency of its working."[58] In many respects this combines the evolutionary beliefs of the new institutional economics movement with the utilitarian traditions inherent in Granovetter's undersocialized social interactions, and takes a

[58] Kenneth Arrow, "The Limits of Organization", New York: Norton, [1974] p 26, cited in Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness", in Granovetter and Swedberg, "THe Sociology of Economic Life", Boulder, Oxford, Westview Press, 1992, at 57

functional view of the notion of trust as little more than a social meme. Granovetter concludes that there must be some “generalized morality” informing economic actions, exemplified by the apocryphal economist who leaves a tip in a roadside restaurant far from home. Here, the transactors are not only unacquainted, but are unlikely to transact in the future and information about the actors or their actions is unlikely to be relayed home to everyday trading partners. This, for Granovetter, is proof of some generalized morality. Such morality may also go some way to explaining the phenomenon of anonymous charity donations, potentially expanding the concept to include some form of “goodwill” or “community”.

The trust engendered by this “general morality” is facilitated by concrete personal relations or “networks” and Granovetter points out that the preference to transact with those of known reputation implies that the existence of either general morality or institutional arrangements is rarely sufficient. A combination of the two is preferred. Furthermore, the potential damage to one’s reputation as a consequence of malfeasance implies an undersocialized conception of reputation as a commodity as it connotes a ratio of cheating opportunities and being caught to potential gains to be made. While this argument fails to take into consideration the social implications of shame and the variable weight placed on this in different cultures, in reality the threat of being “caught fiddling the expenses” is clearly insufficient to prevent the practice.[59]

Repeat trade within a dyad not only enables the construction of an economic relationship but with it the potential for a personal relationship including therein social expectations of abstention from malfeasance and general trust. The example is given by Granovetter in a variation of the Prisoner’s Dilemma in which first individuals in a burning theatre panic and cause a stampede while individuals (typically family members) in a burning house still panic but ensure that everyone is able to exit the premises. In both situations the actions of the individuals are rational, but the difference in the second instance is the social relations that exist between the actors. No-one is confident of being able to count on the actions of others in the theatre as they do not know them, or hence care much for their fate. Conversely the familial or friendship ties in the house imbue the relations with social expectations, and there is no Prisoner’s Dilemma because each is sure the others can be counted on. The Prisoner’s Dilemma here is a good example of rational action with a

[59] Cultural implications abound here. The notion of honor and shame in East Asian cultures would imply that reputational damage may be a stronger incentive not to cheat in some economies as opposed to Western economic culture. It only remains to be pointed out that economic action and social structure interact in cultural specific ways, and that points laid out herein are from a typically Western European approach to economic and legal sociology.

deleterious outcome. Similarly in business, rational self-interest would recommend malfeasance if it increased utility. Yet this can be obviated by the strength of personal relations, this being the property not of the actors themselves but of their concrete relations.[60]

While networks of social relations may temper recourse to malfeasance, institutional arrangements and generalized morality should not necessarily be written off as no longer valid explanatory mechanisms. It is the interaction and close cooperation of various forms of social intercourse that conspire to shape economic interaction. However it should be noted that such networks can in fact facilitate malfeasance to a greater extent that would have been possible without them. For example, crimes such as embezzlement are only possible under a cloak of implicit trust. Furthermore, larger frauds can only be perpetuated by teams of actors working together amidst their own network of relations. Finally, disorder can either be instituted by two actors or by larger groups of individuals, usually having organized themselves into “sides” or “teams” that each develops its own network of relations. A good example of this in the business world is the business of hostile takeovers where each side can call upon business or political allies to support their cause.

“The embeddedness approach to the problem of trust and order in economic life, then, threads its way between the oversocialized approach of generalized morality and the undersocialized one of impersonal, institutional arrangements by following and analyzing concrete patterns of social relations”.[61]

The reputation of credit rating agencies is undoubtedly crucial in their continuing trade.
The importance of trust in the rating industry cannot be overstated and reliance on reputation has been identified as one of the main barriers to competition and new entrants to the CRA market.[62] Investors rely heavily on information disseminated by the agencies while these latter rely on their reputation as a trusted source of information to maintain their market position and justify the large fees charged. The extent of the (over) reliance of market participants on the rating assigned to an investment is picked up in more detail in later sections, however, the trust relations between the parties can be seen to form a triadic relationship, with the CRA forming a nexus attracting trust. The reputational capital of the agency necessitates inflows of trust from both the issuer/arranger and in

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60 See Granovetter, “Economic Action and Social Structure: The Problem of Embeddedness”, in Granovetter and Swedberg, “THe Sociology of Economic Life”, Boulder, Oxford, Westview Press, 1992, at 58.

61 Granovetter, “Economic Action and Social Structure: The Problem of Embeddedness”, in Granovetter and Swedberg, “THe Sociology of Economic Life”, Boulder, Oxford, Westview Press, 1992, at 60.

62 See Commission Staff Working Document accompanying the proposal for a Regulation of the European Parliament and the Council on Credit Rating Agencies, Impact Assessment, COM(2008)704. See also “European Criticizes U.S. Raters of Credit”, New York Times, May 7th 2010.

turn the investor. The investor trusts the agency to properly investigate, appraise, and rate the investment and the issuer trusts that the agency will assign a suitable rating to their product that will make it viable in the financial markets. By claiming that ratings are mere “opinions”, agencies effectively render immaterial any trust that is placed in the issuer and investor. Ratings, as stated by the agencies, are not intended to be relied upon - they are mere guides. The fact that global financial markets function by doing just that - relying heavily on such ratings - appears to have caused the agencies little concern over the past couple of decades. A concrete personal relationship founded on trust can function well in the marketplace, assuming that trust flows both ways in the relationship. Singular trust flows, coupled with extreme reliance on the trustee (the agency), renders this latter able to abuse this trust with few, if any consequences. The relations between issuers, agencies and investors are best seen as two dyads; issuer/arranger-agency, and investor-agency. In both cases the reputational capital and market dominance of the agency sees trust flowing to the agency only. In both cases the agency is at liberty to abuse this trust. The lack of due diligence on the part of the agencies in rating products, and their inability to clarify and solve conflicts of interest illustrate the abuse of trust placed in them by issuers. The same can be said for investors. This is illustrated below.

Moreover, ratings-based regulations has further reinforced the necessity of placing trust in CRAs. Legislative requirements across the financial sector derive from ratings assigned by agencies. If the government imposes regulatory requirements on companies based on their rating, individuals could not have been expected to single-handedly reappraise and attach less significance to such ratings. The reputational capital of the agencies was, in effect, sanctioned by governments who in turn were just as beholden to the agencies as any private market participant.[63]

Is there a general morality of the CRAs to conduct investigations properly, exercising due diligence and implementing policies of disclosure and transparency? If agencies rely on their reputation surely they will take all reasonable steps to preserve this and facilitate market transactions to the best of their ability and function? As seen, however, not only is it rational behavior for agencies to lower the quality of ratings if they are unlikely to be caught, but the corporate structure and purpose of agencies as private, profit-seeking institutions means that discussions of corporate ‘morality’ need be given several caveats. Moreover, even if ethical consideration could be attributed to the

63 The removal of ratings from legislation in both the US and EU is discussed below in relation to post-crisis regulation of the CRAs.

conduct of CRAs, the question remains whether these should be relied on as overriding methods of regulation of conduct.

It has been posited that ratings agencies perform a public service and should therefore be run by public institutions. Michael Barnier, European Union financial services commissioner, has complained bitterly about the lack of competition and overriding 'American' credit rating agencies operating across the world.[64] Speaking after Moody's put Portugal on its watch list for a downgrade, Barnier stated that it was an "open question" whether an alternative European agency should be run by the private sector or a public body. This prospect has provoked strong opposition from the Bank of England and the Financial Services Authority, among others, who responded to the European Commission's consultation on credit rating agencies.[65] They warned of the "high political pressure" that any public rating agency could face from Member State governments and suggested that important institutions facing downgrades by a European public agency could necessitate promises of government backing much earlier in the day.[66] When a public service is provided, theories of embedded networks of social relations again cease to be relevant. Notions of trust are again useless here as trust flows in one direction only. While it is easy to see why the public service provision conclusion could be reached in regard to securities ratings, the nationalization of part or all of this sector would signal the end of notions of reputational capital, trust, or embedded networks. It is submitted that a conclusion this drastic is not necessary while there are alternative, complementary methods of regulation left to be explored.

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[64] "European Criticizes U.S. Raters or Credit", New York Times, May 7th 2010.

[65] "UK Authorities Oppose European Public Credit Rating Agency", Dow Jones, January 18th 2011

[66] Ibid.

Regulation

As noted above, credit rating agencies were subject to various financial services directives, notably the Market Abuse and Capital Requirements Directives.[67] They continue to be subject to the voluntary International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for credit rating agencies.[68] Various options were explored by the Commission, ranging from enhanced self-regulation to pan-European legal frameworks. A Commission Staff Working Document accompanying the proposal for a regulation concluded that as self-regulation had proved unsatisfactory prior to the financial crisis there was no reason to suppose that it would be anything other than the same ex post.[69] The favored approach was one of harmonized legal standards across the Union, based on a new Regulation.

Following the financial crisis governments began to call for regulatory reform of the CRAs. A G20 communiqué of April 2009 declared that the leaders had "agreed on more effective oversight of the activities of Credit Rating Agencies, as they are essential market participants".[70] The self-regulating code of conduct so favored by EU regulators has been modified in the areas of the quality and integrity of the ratings process, conflicts of interest, and the CRA's responsibilities towards investors and issuers.[71] The European Parliament has proposed a new regulation on CRAs which includes a legally binding registration and surveillance process.[72] At the national level, in the US the SEC has adopted an amendment to NRSRO regulations which aims to further enhance the utility of disclosure to investors, strengthen the integrity of the ratings process and address the conflicts of interest inherent in rating structured finance products.[73]

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[67] See Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (OJ L 96, 12.4.2003, p. 16).

[68] Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf

[69] *Commission Staff Working Document accompanying the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*, COM (2008) 704, November 12, 2008.

[70] Global Plan Annex: Declaration on Strengthening the Financial System Statement Issued by the G20 Leaders, April 2, 2009, London. Cited in Rousseau, Stephane, Regulating Credit Rating Agencies after the Financial Crisis: The Long and Winding Road Toward Accountability (July 23, 2009). Capital Markets Institute Research Paper. Available at SSRN: http://ssrn.com/abstract=1456708, at 27.

[71] International Organization of Securities Commissions, *Report on the Subprime Crisis -Final Report*, May 2008. Cited in Rousseau, Stephane, Regulating Credit Rating Agencies after the Financial Crisis: The Long and Winding Road Toward Accountability (July 23, 2009). Capital Markets Institute Research Paper. Available at SSRN: http://ssrn.com/abstract=1456708, at 27.

[72] European Parliament, *Draft Report on the proposal for a regulation of the European Parliament and of the Council on Credit Rating Agencies*, COM (2008) 0704 – C6-0397/2008 – 2008/0217 (COD), January 13, 2009.

[73] U.S., Securities and Exchange Commission, *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Release No. 34–59342; File No. S7–13–08, Federal Register, vol. 74, no. 25, 6456. Cited Rousseau, Stephane, Regulating Credit Rating Agencies after the Financial Crisis: The Long and Winding Road Toward Accountability (July 23, 2009). Capital Markets Institute Research Paper. Available at SSRN: http://ssrn.com/abstract=1456708, at 28.

The proposed regulations seek to place higher demands on the CRAs to reappraise their own methods and models regularly in particular with regard to ascertaining the reliability of rated debts. The information used by the CRAs should also be reviewed to be certain that it is of sufficient quality to support the resulting ratings. Employees of the rating agencies must also be suitably trained and versed in the products they are rating and must be given adequate support to understand such.

In 2007 the European Commission instructed the Committee of European Securities Regulators (CESR) and the European Securities Markets Expert Group (ESME) to examine and advise on various aspects of the activity of CRAs and their role in the financial markets, in particular with regard to structured finance. For its part, the Commission undertook major consultative processes from a wide range of associations, market participants and stakeholders.

The CESR was asked to monitor the compliance of CRAs with the IOSCO code of conduct and report back to the Commission on an annual basis. The basic conclusion reached was that - barring some non-essential deviations - the CRAs had implemented the code adequately. In September 2007 the remit was expanded to include structured finance and to re-evaluate regulatory options in the area. The resulting report made recommendations in four areas.

1. *Transparency* - The report recommended that CRAs should communicate the characteristics and limitations of the ratings, and should give information on critical model assumptions. Ratings should contain the methodology used, and information on rating performance should be provided in a standardized, publicly available format.
2. *Human Resources* - The report recommended that CRAs disclose sensitive human resources indicators, and should ensure that remuneration structures are appropriate to promote independence and avoid conflicts of interest.
3. *Monitoring of Ratings* - CRAs should ensure that the monitoring of their ratings remains effective.
4. *Conflicts of Interest* - CRAs should ensure full transparency with regard to the exact nature of their interaction with issuers/arrangers of structured finance products, as this interaction can give rise to conflicts of interest. CRAs should, the report also recommended, have strong procedures in place to monitor and control this interaction, and there should be a common definition on what constitutes advisory practice and a definition of what constitutes ancillary business. CRAs should be transparent in the disclosure of fees they receive from investors.

The CESR report concluded that the IOSCO Code served as a suitable minimum level of regulation, but that an enhanced regulatory framework should be built around this. The report recommended that the Commission form "as an immediate step, a CRAs standard-setting and monitoring body with the following objectives:"

1. To develop international standards for the rating industry in line with steps being taken by IOSCO.

2. To monitor the compliance of CRAs to those standards, using full transparency as the method for enforcement and having the "name and shame" capacity.

By contrast the report from the ESME investigation focused on the role and operations of CRAs, their business incentives, internal organization implications and market dynamics. In contrast to the CESR report, the ESME report cautions against regulation of CRAs by EU institutions. While the lack of accountability of CRAs to the market was held to be a concern, so were the possible effects of tighter regulatory standards. The report suggested that self-regulation could work, but that the COde need revising and further developments were necessary that went beyond the scope of the Code. The report implicitly called for a European CRA Code of conduct built on IOSCO's. The report contained detailed requirements on methodology and analytics, including:

1. CRAs should agree with market participants on the information that should be disclosed on a pool of assets being securitized. CRAs should also disclose the fee structure for rating that security.

2. The report makes a strong point on corporate governance, notably that each CRA should have an independent policy function accountable for policy, criteria, models and quality assurance.

3. The report considers that the CESR should retain its monitoring role in relation to CRAs. This role, it recommends should be reinforced by an annual external audit on corporate governance in each CRA and by an advisory group that would advise the CESR on significant developments, trends and issues in the credit markets which are relevant and any concerns that arise about trends or issues in the market.[74]

The resulting Regulation 1060/2009 on credit rating agencies also set out the requirement that CESR establish a central repository where CRAs can deposit information on their historical performance including data on ratings transaction frequency and information about credit ratings

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[74] The point should be noted that problems have arisen with lack of due diligence in auditing. Some of the recent financial collapses had been given clean bills of health by their auditors only weeks prior to collapse. Simply putting in place audit requirements will not solve the problem unless these are carried out correctly.

issued in the past and changes made thereto.[75] This information is to be made accessible to the public.

CRAs, under the regulation, require authorization to operate and will be directly supervised. The European Securities and Markets Authority (ESMA) is tasked with this on a day-to-day basis. The Authority also has the power to make dawn raids, impose fines of up to 20% of the previous year's turnover, and to ensure that agencies evaluate the accuracy of past ratings. The European Parliament had pushed to facilitate access to information for CRAs wishing to produce unsolicited ratings, on the grounds that this would increase competition, allow for more transparency, and give investors more information on which to base their decision. The idea was eventually dropped due to reluctance on the part of Member States to adopt it, but the Commission is still bound to table legislative proposals to this end. This is expected to become a focus of Parliament when further changes to the regulations are examined in late 2011.

In March 2008 the Technical Committee of the International Organization of Securities Commission (IOSCO) published a consultation paper on the role of the CRAs in structured finance markets. The revision of the Code of Conduct Fundamentals for CRAs of 2004 was approved in May 2008. The report, while not undertaking criticism of the CRAs or their regulatory structure, looks at the need to reform the Code of Conduct to address the legitimate concerns relating to the activity of the agencies. The report identified several deficiencies in the operations of the CRAs which should be considered from a regulatory perspective. These are set out in Table XX.

Area of Concern	Points Noted
Transparency Issues	1. Performance data are not sufficiently transparent and comparable 2. There are major differences between corporate and structured finance ratings in terms of methodology, data services available and liquidity considerations 3. There is a lack of clarity in terms of the CRAs' policies regarding the review of past ratings and methodologies
Independence	1. The report notes the potential conflicts of interest regarding issuer-pays models and the advisory services offered by the CRAs, but does not go beyond promising new measures that compliment the Code.

[75] Regulation (EC) 10602009 of the European Parliament and Council, 16th September 2009 on credit rating agencies.

Area of Concern	Points Noted
Competition	1. The report recognizes that reputation, which needs to be earned from issuers, may be the largest barrier to entry in the CRA market 2. It also recognizes that the inherently less transparent structured finance markets and limited competition among CRAs may undermine the integrity of the credit rating process of these products

In April 2008 the Financial Stability Forum (FSF) also published a report examining the causes and weaknesses that contributed to the financial turmoil. The report sets out recommendations for increasing the resilience of the markets and institutions going forward. Many of its recommendations are mirrored in the CESR, ESME and IOSCO reports but the FSF report does note stridently that investors should revisit their reliance levels on ratings. The report makes the point that over-reliance on CRAs in the first place was a major factor in the crisis, and encourages a return to due diligence on the part of the investor.

In the US, the Credit Rating Agency Reform Act 2006 came into force in June 2007. As noted already, this established a legal framework for revised NRSRO registration and qualification procedures. In March 2008 the President's Working Group (PWG) announced a set of measures involving CRAs in order to enhance integrity and transparency of the rating process for structured finance products. The SEC put forward the following proposals:

1. Ratings analysts should not be involved in the structuring of a product
2. CRAs shall improve their transparency to allow users to compare ratings
3. CRAs shall disclose the frequency of the revision of a rating and shall be more transparent in the event of a revision
4. CRAs shall use adequate information about the underlying assets of a product that they are rating, and they shall refrain from issuing a rating if the information on the underlying assets is not available. They shall also disclose all due diligence performed to verify the information on the underlying assets[76]
5. CRAs shall disclose all the information they use to produce a rating (including information on the underlying assets) so as to allow broad market scrutiny, as well as competitive analysis by other rating agencies that are not paid by the issuer to rate the product

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[76] The very existence of this recommendation is surprising and points to the absence of levels of due diligence previously.

6. Analysts participating in determining a credit rating should refrain from negotiating the fee that the issuer pays for it, to avoid the practice of "shopping for ratings"
7. Analysts cannot receive gifts from issuers worth more than $25
8. CRAs should differentiate ratings for structured products from ratings for traditional debt (corporate or sovereign) by using different symbols or by disclosing the differences between ratings of structured products and securities.

In addition to legislating the above, in June 2008 the SEC also made public for consultation a package of amendments in US legislation with a view to removing references to NRSRO ratings in US financial law. As mentioned above, the SEC believes that such legislative referencing has contributed to the over-reliance on ratings by market participants. The proposal includes three main measures:

A. To amend various rules and forms under the Securities Exchange Act 1934 to remove several references to NRSROs
B. To replace rule and form requirements under the Securities Act 1033 and the Securities Exchange Act 1934 that rely on securities ratings with alternative requirements
C. To amend rules under the Investment Company Act 1940 and the Investment Advisors Act 1940 that rely on NRSRO ratings.[77]

All of the reforms - proposed by the SEC, the EU and the IOSCO - make claims pertaining to regulation of conflicts of interest that have drawn so much criticism in the wake of the crisis. In particular, the Cuomo settlement, named after New York Attorney General Andrew M. Cuomo, reforms the traditional model of compensation for CRAs. Instead of remuneration based on the publication of a rating amenable to the issuer, the agency will instead be compensated for its undertakings, whether these are publicized or not. The new "fee for service" structure, it is hoped, will make CRAs less vulnerable to pressure from issuers about the level of the rating given.[78]

As mentioned, in the US, new SEC regulations now prohibit the rating by an agency of a product on which it or an affiliate of the agency gave advice.[79] The same SEC amendment also introduces a

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77 Similar calls have been heard in Europe from business leaders, however these have not

78 The Cuomo settlement appears to be non-justiciable. However, it does see agreement between the Attorney General and the three largest CRAs on a number of issues including fee reforms, disclosure reforms, loan originator reviews and due diligence reforms, CRA independence from issuers, and finally issues and warranties required from banks and other issuers with regard to the RMBS issued. See further http://www.ag.ny.gov/media_center/2008/jun/june5a_08.html

79 Rule 17g-5

rule that was present in the IOSCO regulations, namely that a person who participates in determining a credit rating is not permitted to partake in the negotiations for the fee that the issuer pays for it. Finally, conflicts of interests with respect to gifts are also prohibited, recipients of such being barred from participation in the ratings process.[80]

The reforms also seek to enhance transparency, seen to be one of the most effective regulatory mechanisms.[81] EU Regulations also follow a similar approach in calling for disclosure of methodologies, models and key rating assumptions used by agencies in the process of calculating a rating.[82] With regard to disclosure by the CRAs, the SEC requires that NRSROs release all ratings and performance statistics for one, three and ten years within each rating category. EU rules also require the periodic disclosure of details of default rates and CRA performance. Yet arguably, the European rules go further, in requiring the CESR to establish a central depository for standardized data on CRA performance.

With regard to transparency of methodology, SEC requirements now impose CRA disclosure on how the information on underlying assets and quality of originators informs the overall rating. CRAs are also required to make clear how often they review each rating and whether the same methodology is used in surveillance as in the initial assignment. European Commission and IOSCO requirements are broadly similar.

It should be pointed out, however, that the broad sweep of reforms following the financial crisis seek not simply to regulate the CRAs but to reduce reliance by market participants on the ratings. Transparency and disclosure requirements allow the investor to make his own inquiries and conduct his own due diligence based on the same information the agency used. Moreover, transparency of process means that the investor can also see what assumptions and models the rating is based on. While conflicts of interest between the issuer and the agency have been dealt with to a greater or lesser degree, this arguably has not been to reassure or further encourage investor trust of agencies.

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[80] Ibid.

[81] For a general exposition on the benefits of transparency, see Thaler and Sunstein, “Nudge: Improving Decisions about Health, Wealth, and Happiness”, Yale University Press, 2008. Note also the conflation of transparency and disclosure in most arguments.

[82] *Commission Staff Working Document accompanying the Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*, COM (2008) 704, November 12, 2008, p. 8-9. Cited in Rousseau, Stephane, Regulating Credit Rating Agencies after the Financial Crisis: The Long and Winding Road Toward Accountability (July 23, 2009). Capital Markets Institute Research Paper. Available at SSRN: http://ssrn.com/abstract=1456708, at 31.

CRAs have more legal obligations to do their job well, but at the same time, the general move is to rely on them less.

The centralized repository of data relating to CRAs and their performances over a period of years again shifts the burden of due diligence from the agency on to the investor to not only undertake an assessment of the investment he is considering, but an assessment of the agency that has rated the investment, and the extent to which he should rely on, or even take into account, that rating. Moreover, the burden of policing the CRAs has, in these few measures outlined above, shifted from self-regulation to market regulation. While in Europe the ESMA will have daily oversight of the sector, the level of information that appears to be making its way towards the public domain strongly places the emphasis on issuers and investors to do their homework before engaging the services of a CRA. The centralized database in Europe will help market participants and stakeholders in their endeavors.

The Problems with Government Regulation

Unlike banks and other investment institutions, CRAs do not have any financial incentives to provide the best service. A bank may be investing in a venture and therefore has a high incentive to gather and analyze accurate information. A CRA has no such incentive and therefore has the potential to collude with or threaten issuers by means of ratings, creating a potential moral hazard for both agencies and investors. One way of regulating CRAs would be to randomly check their research and conclusions, however this would entail a duplication of efforts in the market, avoidance of which justifies reliance on CRAs in the first place. Moreover, ratings have been treated as 'opinions' in the US, and therefore the subject of free speech under the First Amendment to the Constitution. Furthermore, while the quality of ratings (due diligence) can be verified *ex post*, these are based on statistics and it is difficult to hold that these were substantively wrong, except with the benefit of hindsight. With the exception of outright fraud, CRAs are, by their market position, virtually untouchable. The one bargaining chip the market does have over CRAs however, is their reputation.

The reputation mechanism, while not verifiable *ex ante*, can be tested *ex post*, by correlating assigned ratings to rates of default. Agencies with a strong correlation build a reputation for providing reliable, accurate information about the likelihood of default in their ratings. As a result of a good reputation, investors value the agency's analysis highly, and therefore seek ratings from them as this promises the largest reduction in transaction costs. There is an incentive on the part of the agency to mislead issuers and investors by not carrying out due diligence in assigning the rating. This might increase the agency's profits by reducing their costs. Moreover, due to the unpredictable nature of financial markets and the inherent unverifiability of the rating, it is unlikely that a one-off lapse in performance would not be discovered. However, endemic and systematic neglect of attention in analysis is likely to see a weakening in the correlation between ratings and defaults, and a consequent lowering of the agency's reputation. Issuers are less willing to seek out an agency with a lower reputation, and income and profits will duly fall in future periods.[83] However, if the returns to be made from deceiving issuers, investors, regulators and sovereign states are likely to outweigh those losses resulting from a fall in reputation, it would be rational action on the part of the agency

[83] Moreover, a lower quality rating is likely to summarize less useful information that an investor would not be able to discover for himself. It is therefore proportionally worth less to both transacting parties. A high quality rating includes information not immediately verifiable by the investor without large outlays on his part, and is therefore of greater value to both parties, although this may not be true for some structured finance products which are not publicly traded.

to deceive. A small risk of being uncovered and the ability to blame the financial markets further tips the balance in favor of deceit and general malfeasance.

While this behavior would likely see issuers seek ratings from competitors with intact reputations, the CRA sector does not lend itself to this outcome for two reasons. Firstly there are a limited number of competitors. If three ratings are required for a product then it is likely that all major agencies will be invited to assign the debt a rating. There is little alternative for the discerning issuer. Secondly, owing to the small size of the agency market, an incentive that causes one agency to engage in less than diligent practice is likely also to affect the practices of its rivals. As such, while defaults may start to deviate further from the ascribed ratings, if this takes place among all three agencies, there is no indication that one firm may be at fault - the market has simply become more volatile and consequently less predictable.

The introduction of competition into the CRA market by recent US regulations has also raised many issues. Dittich has analyzed entry to the market and concludes that there are several recent barriers to entry that explain the lack of market entrants, notably regarding the role of reputation in the business model.[84] Entrants to the market with little reputational capital to trade on necessarily have to offer their ratings at a lower price than more established agencies. They reputation will also need to be developed over a period of time and over a number of debt ratings that prove to be accurate, increasing the amount of startup capital required by the agency. Furthermore, existing market participants have acquired an “early mover advantage” over time, and as the ratings market has become more profitable over time, entry barriers have also increased. Issuers also have incentives to remain with the agency that has rated their debts previously for the sake of consistency within the market and ease of comparison on the part of prospective investors. As was noted above, the recent report by IOSCO concluded that reputation, which needs to be earned, will prove to be the toughest barrier to new market entrants. The introduction of competition and registration has seen little alteration in the number of market participants and has had little to no impact on the oligopoly of the “big three”.
Moreover, state regulation of the financial markets is premised on the same assumptions that drive the financial markets and thus the same that inform the economy. As the discussion thus far has

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[84] Fabian Dittrich, “The Credit Rating Industry: Competition and Speculation”, available at http://ssrn.com/abstract=991821, at 31. Shapiro frameworks are used to deal with a deviation from perfect competition, although in many cases there are arguably deviations from a sociologically-oriented understanding of the markets, which lessens the impact of the study. Perfect elasticity of demand, for example, in a very small, highly profitable sector with divergent cost strategies among competitors is unrealistic.

shown, the credit ratings sector is one which does not lend itself to classical economic reasoning. The introduction of competition may have been a worthwhile goal but the process was undertaken without considering the basic tenet of the market - reputational capital. Is it this that prohibits new players from entering the market and competing on the same level as established agencies. It is this reason again that prompted some to call for public, or state-owned, rating agencies.[85] The introduction of competition by the Labour government in 2006 into the CRA sector may have been wishful thinking. As stated, CRAs rely on their - un-valuable - reputation. Thus, economic competition between CRAs must necessarily be based on something which is inherently incapable of being assigned an economic value. The previous discussion has already address the potential for rate inflation and the factors that may prevent this.[86] A comparison may be drawn here between the rating agency sector and school exam boards. Competition between the exam boards for business - for schools to pay for pupils to take their particular maths GCSE, for example - has consistently led to accusations of boards competing for business by making their exams slightly more straightforward that their competitors.[87] The aim is that more students receive higher grades, and everyone is, supposedly happy but none the wiser as to exactly how to compare the eventual results. This effect of competition in this scenario, accurate or not, is likely to be mirrored in the rating agency market. This could not only lead to situations where ratings across markets and agencies become even less capable of comparison, but could serve to further undermine trust in the agencies, who are simply seen as offering the best rating.

The drive to improve transparency does not take into account the fact that in increasingly deregulated labour markets where people expect to move from job to job, the instances of conflicts of interest and possibilities for insider dealing will also increase. Enhancing transparency may serve to highlight issues where this is a potential, but only full disclosure of all data, sources and assumptions can prevent the worst effects of these. Enhancing transparency is a distraction here from the main reform that is necessary - full disclosure of all material to the market. However, this is unlikely due to the adverse effects it would have on the credit ratings industry.

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[85] See above, at XX

[86] Above, at XX

[87] There are hundreds of articles discussing this phenomenon. For a selection, see "Exam Board EdExcel 'battery farming pupils to improve GCSE passes'", The Times, May 21, 2008; "Are teachers choosing 'easy' exam boards", The Guardian, Tuesday 25th August 2009; See also http://bluetutors.co.uk/tutor_articles/2010/05/Why-Are-There-So-Many-Examination-Boards/145

Furthermore, regulations to date do not take into consideration the fact that finance and the markets are social phenomena, and are thus constantly evolving in the way any social phenomenon might. Disclosure of information may shift the burden of due diligence away from the CRA, but in the current crisis the products being rated were new to the market. No experience of such existed, and all the disclosure requirements possible could not have allowed investors to effectively understand the full processes and products that they were investing in. Not only are new financial products being designed every day, but the pace of innovation in the sector is increasing. Disclosure and transparency alone will not allow for a full comprehension and risk analysis when there are no previous examples to make comparisons with and learn from. Coupled with rapid developments in the financial sector, in particular regarding structured finance products, social relations are also evolving continually. The expansion of financial market oversight, exemplified by CRA reforms both in the EU and US, is a prime example of further government regulation to facilitate the free market through neoliberal, laissez-faire economic policies. It is these policies that were found so wanting in the wake of the crisis. The fact that the reforms have not been more sweeping may indicate a reappraisal of the ideology underlying the reforms, however the steps taken are still in the same direction that governments have been traveling in for the past two to three decades.

Trust is less necessary when there is government regulation standing in to do the same job. In this regard, the introduction of further regulation both sees an approach to further social and economic atomization - via the path of undersocialization in that regulation and government intervention takes the place of social networks and trust, and via the path of oversocialization in that ideals and standards for social benefit become embodied in legislation and thereby pervade all social interactions, perpetuating their internalization by the individual and informing his actions and interactions. That these standards are intended to improve certainty in the financial markets and thereby improve the lot of the individual and his mortgage payments and pension payouts - and can therefore be classified as being socially motivated - does not differentiate the argument from a utilitarian one in which the source of utility function is left open but the result is to maximize total overall welfare, in this instance within the framework of a free market economy. By whatever means, the further atomization of economic society results.

So What Do We Need Now?

The role of knowledge in investment decision-making is at the heart of embedded knowledge network activity.[88] The rating supplied by the CRA is a typical form of knowledge output that seeks to condense the overwhelming flow of information into little more than three letters for the benefit of the bewildered investor. While such benchmarks can be departed from, they provide a standard for the work of other actors against which successes and failures can be measured. As endogenous structures, the networks play a constructivist role in the creation of markets in a context of uncertainty and imperfect information.[89]

Acting as embedded knowledge networks, rating agencies can be said to “adjust” the ground rules informing international capital markets.[90] In the same way they also inform the behavior of issuers and institutions seeking funds within that market. The expectations of the agencies shapes the actions of those who seek a favorable response in the form of a high rating. This “anticipation effect” is a result of capital markets participants’ understandings of what agencies view as acceptable, leading to a base on which corporate policy initiatives and structures are developed.[91] The low level of market participants in the ratings sector and relative homogeneity of practice results in a transparent set of norms that are understood by and shared among all market participants. The CRAs therefore do more than constrain market function. They actively shape the conduct of those who partake in capital markets, developing what Sinclair refers to as their “internal constitution”.[92]

The ratings that inform so much of the function and regulation of the market can be understood as intersubjective interpolations of fact. This is partly due to wrongly attributed authority by market participants and society to the agencies, but also by governments. Furthermore, the way in which the intersubjective acceptance of ratings as aphorisms of market values and probabilities affects the social context in which corporate and government policy plans are made contributes to the furtherance of the authority with which actors imbue ratings. Even when analysis shows agency assumptions to be flawed, or ratings to be of low quality, the authority attributed to the ratings

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88 See T.J. Sinclair, *The New Masters of Capital*, Ithaca, Cornell University Press, 2005, at 15

89 The constructivist understanding of agencies according to an economic sociology is to be contrasted with a rationalist account taken by counterfactualists. For realistic purposes, it is assumed that a constructivist economic sociology heuristic complements the rationalist account of the function of rating agencies. For more on this see See T.J. Sinclair, *The New Masters of Capital*, Ithaca, Cornell University Press, 2005, at 17.

90 Ibid

91 Ibid.

92 Ibid, at 16.

remains undiminished because of the hegemonic nature of what Sinclair refers to as the "mental framework of rating orthodoxy".[93] Characteristic of western rationality, and increasingly perpetuated in international contexts by the CRAs themselves, this sees the role of the agency as an embedded knowledge network perpetuated through socially attributed authority, giving ratings the status of economic axioms. This is one way of explaining the rating as a self-fulfilling prophecy that continues to cause havoc among European sovereign states. The internationalization of rating agencies drives with it not only the global consumerization of nation states, but the relentless seepage of American ideas of "best practice" into state and corporate function around the world. Rating agencies perpetuate this, along with other western policy institutions such as the IMF and World Bank.[94]

Investment may be understood not simply as Hayek's automatic result of the realization of certain basic conditions, but as an "implicitly coordinated social process".[95] The displacement of banks as the principal resources of capital by bond markets has propelled the rating agencies into the role of the 'gatekeeper' of markets, inasmuch as the agencies are the sole means by which policy orthodoxy and managerial best practice is transmitted within the market. The agencies are the gatekeepers to capital for governments and corporations alike. At the same time they are 'gateopeners' for issuers and financial development specialists. The centralization, privatization and globalization of investment judgment not only cements the role of rating agencies as an information nexus, but further solidifies endogenous systems of rationality within society apportioning fundamental authority to ratings and the agencies that assign them.

Furthermore, judgments by rating agencies are just that - judgments. They are the opinions of individuals, broadcast and backed by the reputational value of the agency. It is this broader reputational value and the social authority gained from such that propel the rating from the idiosyncratic view of the individual to an axiom of intersubjective consequence.

The individual here is understood as functioning within the embedded knowledge network that characterizes the CRA. The atomization of the individual within this network by the exponential growth and internationalization, and resulting corporate anonymity of such over recent years may weaken the function of the network itself. However the authority attributed to ratings by

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93 Ibid at 17.

94 The emergence of 'other' capitalisms as a response to American neo-liberal hegemony may mitigate Sinclair's suggestion that CRAs, as the IMF and World Bank, perpetuate the globalization of western practices and rationalities. Chinese capitalism as it develops, is different from Russian capitalism, which in turn both differ starkly from American capitalism. An example of this is the emerging Da-Gong rating agency in China. Ratings assigned by Da Gong to some European states and the US - perhaps unsurprisingly - differ sharply from those assigned by Moody's and S&Ps.

95 See T.J. Sinclair, *The New Masters of Capital*, Ithaca, Cornell University Press, 2005, At 18

rationalizations within society remains unchanged. In other words, the quality of the rating will fall, but the weight given to the rating by market participants, governments and society will remain undiminished - indeed, the continuation of the cementing of cycles of endogenous belief structures may see this strengthen.

The knowledge that informs financial markets tends to be dominated by analytical processes that ask how things should or do function. This approach tends to neglect the evolution and continuous development of the institutions that structure the markets, ignoring completely future developments and the changing context in which institutions function. The same functional analysis of agencies was relied on even when the market had evolved and agencies were rating new products on a daily basis. Again, the reputational mechanism, if embedded in static knowledge systems, will cease to have an regulatory effect once significant developments in the markets occur.[96] History should inform us that this is likely to happen regularly.

Based in static forms of knowledge, ratings retard social appreciation of institutional evolution, demanding change that challenges the status quo. The internationalization of rating agencies, while not consciously attempting to transmit received governance structures, disseminate these through hidden assumptions and practices that work to prioritize these over competing social governance structures. When transmitted around the world these shape the nature of working life and labour markets on a national and international scale and the limits of democracy, making the former less secure and more competitive, and the latter less inclusive and meaningful.[97]

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[96] For more on static knowledge systems see Georges Sorel, “Reflections on Violence”, trans. T. E. Hulme and J. Roth, (New York: Collier), 1961, at 141. Cited in See T.J. Sinclair, *The New Masters of Capital*, Ithaca, Cornell University Press, 2005, at 19.

[97] See T.J. Sinclair, *The New Masters of Capital*, Ithaca, Cornell University Press, 2005, at 20