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The Politics of Regulating Credit Rating Agencies in the European Union

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THE POLITICS OF REGULATING CREDIT RATING AGENCIES IN THE EUROPEAN UNION

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Abstract

Why did the European Union (EU) decide to regulate Credit Rating Agencies (CRAs), instead of relying on the revised rules agreed at the international level and the revised US law to which the main CRAs operating in the EU but headquartered in the US were subject to? This research addresses this key question concerning the multi-level governance of financial services using a 'soft' rational choice institutionalist framework. It is argued that the global financial crisis, acting as an exogenous shock, triggered three causal mechanisms that led to a new institutional equilibrium within and without the EU, namely the issuing of EU rules on CRAs.

Key words: credit rating agencies, European Union, regulation, financial services, political economy

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Introduction

The global financial turmoil that erupted full force in 2008 brought the role of credit rating agencies (CRAs) into the spotlight because the agencies were regarded as being amongst the main 'culprits' of the crisis. In April 2008, the Financial Stability Forum (FSF) issued a report that indicated the activity of CRAs as one of the main areas requiring policy-makers attention in the regulatory response to the crisis (FSF 2008). Consequently, a host of new policy initiatives concerning the regulation of CRAs gained worldwide momentum. In the US, the Securities and Exchanges Commission (SEC) revised its rules on CRAs issued in 2006 (SEC 2009). The International Organisation of Securities Commission (IOSCO) revised the voluntary Code of Conduct Fundamentals for CRAs issued in 2004 (IOSCO 2008). In the European Union (EU), in November 2008 the European Commission (henceforth, the Commission) put forward a proposal for a regulation on CRAs (Commission 2008), which was subsequently co-decided by the Council and the European Parliament.

The decision of the EU to regulate the market for CRAs is rather puzzling because prior to the financial crisis CRAs were not regulated in the EU. On the one hand, it is certainly true that CRAs were criticised for their role in the building up and unfolding of the financial crisis (FSF 2008, Group of Thirty 2009, de Larosiere Group 2009, Committee on Oversight and Government Reforms 2008). Hence, a revision of the existing regulation of CRAs was deemed necessary. On the other hand, the few past attempts to regulate CRAs in the EU had found little support amongst EU policy-makers, first and foremost, the Commission, national supervisors gathered in the Committee of European Securities Supervisors (CESR), and the majority of the member states. In the wake of the financial crisis, some member states, notably the UK and the Netherlands, continued to be lukewarm towards the prospect of EU legislation on CRAs. The two EU-level expert bodies to which the Commission commissioned reports on this matter, the CESR (2008) and the European Securities Markets Experts (ESME) (2008), advised against the issuing of EU legislation on CRAs.

Three main factors militated against the establishment of EU rules on CRAs and very much highlight the multi-level governance of financial services (Baker et al 2005). To begin with, CRAs were already subject to 'soft' international law issued by the IOSCO. Moreover, the main CRAs operating in the EU were headquartered in the US and were therefore subject to US law. The revision of the IOSCO Code and the SEC rules in the wake of the financial turmoil where designed to tighten up the regulation of CRAs internationally and in the US respectively. Finally, EU legislation on CRAs could have potential extra-territorial effects.

Why did the EU decide to regulate CRAs? Which were the most contentious issues and why? How did policy makers and stakeholders articulate their policy preferences in the EU regulatory process and with what outcome? How did the EU rule-making process

interact with international and third country rules and regulatory processes? How did policy-makers and stakeholders pursue their policy preferences in a multi-level regulatory space?

This paper sets out to address these key questions concerning the multi-level governance of financial services by using a theoretical framework informed by 'soft' rational choice institutionalism (RCI) and by engaging in process tracing. It is argued that the regulation on CRAs in the EU was triggered by the global financial turmoil, which acted as an exogenous variable through three main causal mechanisms: it triggered the 'functional' quest for a more effective regulatory framework for CRAs and altered the bargaining power of the main actors involved the 'regulatory game' within and without the EU. In developing these arguments, this paper contributes to the literature on the political economy of market regulation in the EU, elucidating how this interacts with the international political economy of financial market regulation. It also attempts to conceptualise the effects of the global financial crisis on financial services governance in the EU.

2. A 'soft' rational choice institutionalist framework

This research aims to explain institutional change involved in the creation of new EU legislation on CRAs. In line with most of the institutionalist literature, including the often cited definition of institutions put forwards by North (1990), 'rules' are considered as 'institutions' (see also Crawford and Ostrom 1995, Heritier 2007). According to North (1990), institutions are rules that forbid, permit or require some action and are actually used, monitored and enforced.

This analysis is framed by a 'soft' rational choice institutionalist framework (for a review of different types of institutionalism in political science see Hall and Taylor 1996, Peters 1999; for a review of institutionalism applied to the EU see Armstrong and Bulmer 1998, Dowding 2000, Jupille and Caporaso 1999, Schneider and Aspinwall 2001). The choice of RCI instead of other forms of institutionalism is justified by the fact that RCI seems to provide the most suitable framework to explain institutional change (in this specific case, the creation of new rules), whereas historical and sociological institutionalism are generally better suited to account for institutional stability or inertia (Stacey and Rittberger 2003). The 'soft' version of RCI has been chosen given the difficulty of formally modelling the preferences and power resources of policy-makers and stakeholders located in a multi-level policy space.

As pointed out by Pollack (2001), RCI in EU studies has tended either to use formal models to analyse voting patterns and coalition formation in the legislative process in the European Parliament (EP), the Council and its committees (comitology) (see Tsebelis et al. 2001), or to apply the principal agent model to the activity of the European Court of Justice, the Commission and the European Central Bank (Garett 1992, Pollack 2003, Elgie

2002). However, relatively few scholars have used a non principal-agent based RCI to gather a better understanding of the making of public polices in the EU. The most recent exception is the soft RCI applied to a variety of EU policy-processes by Heritier (2007) and Tallberg's rationalist theory of formal leadership with reference to the Presidency of the EU (2006).

The assumptions of the soft RCI that frames this research are that policy-makers and stakeholders are rational utility maximisers, pursuing their own interests, in a policy context with imperfect information. The policy preferences of actors are primarily driven by political economy considerations, they are endowed with different power and resources, and their actions are constrained or facilitated by the institutional environment in which they interact. The players of the regulatory game – which includes both public and private actors - are located at different levels of governance (national, EU, international, including the US).

The *dependent* variable of the research is the establishment of EU rules on CRAs –hence, the process and outcome of rule-making in the EU. The *independent* variables are the policy preferences (or interests) of the main policy-makers and stakeholders, as determined by the costs and benefits ensuing from regulation for the actors involved and their power resources. The *intervening* institutional variables are the support (or lack of support) for rules on CRAs by the Commission, the EU Presidency in office, and a critical mass of member states in the Council of Ministers. The research identifies the global financial crisis as an exogenous shock, or an *antecedent* variable, that altered the bargaining power of the main actors and shifted the equilibrium of the game (i.e. regulatory framework) towards a new institutional outcome, namely the issuing of EU legislation on CRAs. The paper seeks to inductively tease out the causal mechanisms through which this has taken place.

The research is operationalised in the following way. First, the role of CRAs in the financial crisis is explained, outlining the antecedent variable that prompted the functional need for the revising the regulation of CRA and changed actors' bargaining power. Second, regulatory alternatives to EU legislation on CRAs are outlined, reviewing first the IOSCO Code on CRAs at the international level and then the US law on CRAs. This discussion is necessary because both sets of rules affect the activities of CRAs operating in the EU or whose ratings are used by issuers in the EU market. Thirdly, by tracing the regulatory process that led to the regulation on CRAs in the EU, the independent variables, namely the policy preferences of the main policymakers and stakeholders and their bargaining power are explained, as well as outlining the intervening variables within the existing EU institutional environment. Subsequently, the paper outlines the dependent variable, namely the establishment of EU rules and the most controversial issues concerning the content of such rules. Finally, the penultimate section teases out the causal mechanisms set in motion by the global financial crisis that tipped the balance in favour of the specific institutional trajectory of regulating CRAs in the EU.

3. The activities of CRAs and their role in the financial crisis

CRAs are private sector actors that perform three main functions in the financial markets. First, they assess the creditworthiness (probability of default or expected losses) of private companies, public bodies (e.g. municipalities), sovereign states (Sinclair 2005, Bruner and Abdelal 2005) and more recently structured financial products. Second, they provide a variety of additional ancillary services to issuers of securities, such as investment advice on how to place the securities they have rated in the market. Thirdly, the ratings of CRAs have been 'hardwired' into international, EU and national rules. The main example is the Basel II accord (2005), which is an international gentlemen's agreement concerning capital requirements (Wood 2005). The Accord was incorporated into EU legislation through the Capital Requirements Directive (CRD) (2006), subsequently transposed in the member states. The Basel II accord has also been incorporated in national legislation outside the EU, for example in the US.

There are around 130 to 150 corporate rating agencies worldwide (Basel Committee on Banking Supervision, BCBS 2000). Most of those agencies are small and typically focus on a particular jurisdiction or economic sector. The European and global markets are dominated by three agencies that rate the debt of major corporations and nations: Standard & Poor's, Moody's and Fitch Ratings. Moody's and Standard & Poor's have a combined market share in excess of 80%, while Fitch's market share is approximately 14% (Commission 2008b).

When the financial turmoil erupted in 2007, the CRAs were strongly criticised for their role in leading to the crisis (FSF 2008, Group of Thirty 2009, de Lariosiere Group 2009, Committee on Oversight and Government Reforms 2008). To begin with, they substantially over-rated many complex securities created through the financial activity of securitisation, whereby various types of debt, such as mortgages, or credit card debt, are pooled together and packaged as bonds, securities, or collateralized debt obligations. These structured products were subsequently sold by banks and financial intermediaries to investors, instead of being retained on the books of the originators of the financial instrument. The CRAs were also slow in revising their ratings once market conditions deteriorated.

In many cases, the products that the CRAs were asked to rate were too complex to be rated at all, and/or the CRAs did not have access to all the relevant information. Despite this, the CRAs did not refuse to provide ratings. The over-generous rating of securities that were too complex to be rated at all were influenced by the strong competition taking place between CRAs in order to attract clients. Moreover, the fact that CRAs provide a variety of other services to the potential issuers requiring rating meant that the CRAs had a strong incentive not to refuse any rating and to be generous in their assessment of creditworthiness.

To sum up, the CRAs have been blamed for of failing to spot the size and risk of the bad US housing debt that was resold around the world, causing multi-billion-pound losses. Securitised products awarded with the highest rating grade amounted to 75% of those rated by the rating agencies (Commission 2008b). It was the discovery of these losses – the so-called sub prime crisis - that caused the global credit markets to freeze up, spreading the financial crisis internationally. In turn, this led to a functional response in the revision of the existing rules worldwide, as they had manifestly failed to prevent the crisis.

4. The IOSCO Code of Conduct Fundamentals for CRAs

Internationally, CRAs are regulated by a voluntary Code of Conduct Fundamentals issued by IOSCO in 2004 (IOSCO 2004) and revised in 2008 (IOSCO 2008). As explained in Section 6, the compliance of CRAs with the Code has been monitored in the EU by the CESR. The Code works on a 'comply or explain' basis — i.e. credit rating agencies are expected to incorporate all the provisions of the IOSCO Code into their own internal codes of conduct. Where they choose not to do this, they must explain how their code nevertheless gives effect to the provisions of the IOSCO Code. The IOSCO Code is meant to be applied by rating agencies of all sizes and business models and in every jurisdiction. It is a market driven compliance mechanism.

The rather unusual step of having a voluntary code of conduct issued by an international regulatory body, the IOSCO, followed the IOSCO's publication in September 2003 of the 'Principles Regarding the Activities of Credit Rating Agencies' (IOSCO 2003). The Principles, which outlined high-level objectives, were designed to be a tool for securities regulators, rating agencies and other interested parties wishing to regulate the activity of CRAs. Following publication of the Principles, some commentators, including a number of CRAs, suggested that it would be useful if IOSCO could develop a more specific and detailed code of conduct giving guidance on how the principles could be implemented in practice (IOSCO 2004). In addition, a series of significant corporate failures, such as the collapse of the US energy group Enron, and subsequently the Italian dairy group Parmalat, drew policy-makers attention to the activity of CRAs, which had failed to spot problems in the companies concerned.

As with the principles that preceded them, the Code fundamentals were developed out of discussions among IOSCO members, CRAs, representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the interested public (interview, Madrid, April 2009). The Code contained rules on that very draw upon the substance of the principles, namely: the quality and integrity of the rating process; CRAs independence and the avoidance of conflicts of interest; and CRA responsibilities to the investing public and issuers (IOSCO 2004: 3). As explained by Philippe Richard, the secretary general of the IOSCO in a letter to the *Financial Times*, January 7, 2005. p.14

> …it was always intended that the code fundamentals should be sufficiently flexible to accommodate the wide variations that exist between the legal and market circumstances that apply in different jurisdictions. Indeed, the advantage of this flexibility is that any jurisdiction that has the power and the need to do so may supplement the code fundamentals with additional regulatory measures or incorporate it into its own regulatory requirements.

As explained in the previous section, CRAs were heavily criticised for underestimating the risks attached to large volumes of mortgage-related bonds and collateralised debt obligations, which triggered the global financial crisis in 2007-8. Hence, a 'functional' revision of the IOSCO Code was deemed necessary, as the existing rules had been proven to be not fit for purpose. In January 2008 the five main CRAs jointly addressed a white paper to regulators with 12 proposals to improve the IOSCO Code in relation to the independence, quality and transparency of credit ratings. The IOSCO issued a revised Code of Conduct Fundamentals for CRAs in May 2008 (IOSCO 2008).

The amendments to the IOSCO Code concerned the following measures: the strengthening of rules designed to avoid or limit conflicts of interests (for example prohibiting analysts from advising on the design of structured finance products rated by the agency); enhancing the transparency of CRA methodologies and ratings (for example, prescribing the use of a separate set of rating symbols for structured finance products); improving the quality of rating (for example, ensuring that the data used for the rating are of a sufficiently good quality and the refusal of ratings if sufficient quality data are not available or the structured product is too complex).

The IOSCO Code provided the benchmark for the Commission's draft regulation on CRAs (Commission 2008a,b), which indeed contained most of the provisions of the Code, even though it was more detailed in some respects, as explained in Section 7. In the wake of the financial crisis, the revisions of rules concerning CRAs also took place in another key jurisdiction, the US. The US law was also largely based on the IOSCO Code. The main difference between the IOSCO Code and the US and EU legislation is that the former is not (nor could it be) legally binding, whereas national and EU laws are legally binding. The US and EU laws also prescribe distinctive processes of registration for CRAs in their respective jurisdictions, unlike the IOSCO rules, which do not envisage the registration of CRAs. It should also be noted that discussions amongst regulators at the IOSCO were instrumental in facilitating the settlement of the issues raised by the potential extra-territorial impact of the proposed EU rules discussed in Section 7 (interview, Madrid, April 2009).

5. Regulating CRAs in the US

Given the fact that the largest CRAs are based in the US but operate worldwide in a sort of oligopolistic market (Sinclair 2005), the regulation of CRAs in the US has de facto extra-territorial effects in the EU. In the US, the SEC introduced rating into the

regulatory system in 1975, creating the concept of 'Nationally Recognized Statistical Rating Organisations' (NRSROs), whereby corporate bond ratings were used to help set minimum capital requirements for brokers-dealers. The NRSROs were not legally defined by the SEC rules and were traditionally recognised as such by SEC staff through the no-action letter process (Sinclair 2005). Afterward, the SEC did some work in order to develop rules concerning the NRSROs, but for decades progress were slow, and no statutory rules were issued.

Following the Enron scandal in 2002, the Senate Governmental Affairs Committee investigated the activity of rating agencies and concluded that meaningful SEC oversight was needed. The following year, the SEC published its own report that also found serious problems with credit rating agencies. In June 2003, the SEC issued a concept release seeking comments on possible new regulations. Two years later, in April 2005, the SEC issued a proposed rule (*Financial Times* 4 March 2005. p.2). In 2006, the Congress eventually passed a law that set up a new regulatory framework for CRAs that assess corporate and government debt, modifying the system that had been in place since 1975.

Prior to the 2006 bill, the SEC had designated only five NRSROs: Moody's, S&P, Fitch, A.M. Best, which specialises in insurance ratings, and Canada's Dominion Bond Rating Service. By contrast, there were 125 credit rating agencies in the US without the NRSRO status, which hampered their ability to expand. Some CRAs that had applied to the SEC for the NRSRO status had to wait years for a decision, based on vague criteria such as being 'nationally recognised' (*Financial Times* 14 July 2006. p.24). The sponsor of the 2006 bill, which was backed by the White House, argued that this had created an 'artificial barrier to entry' in a market that had already oligopolistic tendencies.

The bill replaced the SEC's NRSRO designation with a formal registration system and gave the SEC supervisory and investigatory powers in this respect. A CRA is able to register with the SEC if the CRA has been in business as a credit rating agency for at least the past 3 consecutive years and issues credit ratings certified by at least 10 qualified institutional buyers (*Financial Times* 14 July 2006 p.24). The SEC must grant registration within a certain time-frame if the requirements are satisfied. Such requirements do not cover the substance of the ratings or the procedures by which CRAs determine their ratings. Once registered, each NRSRO must certify every year that it still complies with the registration criteria. The SEC is authorised by the Act to suspend or revoke the registration in case of non-compliance. In 2008, there were nine NRSROs: AM Best; DBRS; Egan-Jones Rating; Fitch; Japan Credit Rating Agency Ltd; LACE Financial Corp; Moody's; Rating and Investment Information; and S&P (ESME 2008).

In the wake of the financial crisis, in March 2008 the U.S. President's Working Group (PWG 2008) announced a set of measures involving CRAs in order to enhance integrity and transparency on the rating process for structured credit products. The SEC presented

the broad lines of its proposal on CRAs in June 2008[2] with a view to address conflicts of interest, quality of ratings and transparency. Many of the changes proposed mirrored changes made to the IOSCO Code. On 1 July 2008, the SEC also issued for consultation a series of amendments of the US legislation. The aim was to review all references to NRSRO ratings in US financial law on the ground that these references in the legislation might have contributed to an undue reliance on NRSRO ratings by market participants (*Financial Times*, 22 July 2008. p.11).

In February 2009, the SEC issued new credit rating rules that affect NRSROs' record keeping procedures, conflict of interest rules, annual reporting methods and disclosure practices (SEC 2009). Many of the revisions enacted were similar to the rules included in the proposed EU regulation on CRAs. The main difference between the two sets of rules concerned the registration and authorisation process and the potential extra-territorial effects.[3]

6. The process of rule making on CRAs in the EU

Prior to the proposal for a regulation on CRAs put forward by the Commission in November 2008, CRAs were only subject to Community legislation to a very limited extent. In fact, they were referred to in the Market Abuse Directive by provisions concerning the presentation of rating and the disclosure of conflicts of interest. They were also mentioned in the CRD with reference to the determination of risk weights relevant to the calculation of capital requirements (ESME 2008). CRAs needed to have the status of Eligible Credit Assessment Institutions in order for their ratings to be use to calculate capital requirements according to the CRD. The mechanism for such recognition was set up by the Committee of European Banking Supervisors in the implementation of the CRD.

Over the last decade, there had been some short-lived attempts to consider the introduction of EU legislation on CRAs. These attempts did not make much of an inroad for three main institutional reasons, which can be seen as intervening variables and which changed after the global financial turmoil. First, there was not a critical mass of policy-makers supporting them in the Council: whereas certain member states, first and foremost France and Germany, favoured regulating CRAs in the EU,[4] other member states led by the UK and comprising Ireland, the Netherlands and most of the Nordic countries opposed such rules (interviews, London, May 2007; Paris, July 2007; Berlin, April 2008; Rome, December 2007).

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[2] More information can be found at www.sec.gov/rules/proposed.shtml accessed in March 2009.

[3] There are also differences in the level of detail included, which was greater in the EU, and some internal governance aspects.

[4] For example, the French Autorité des marchés financiers (AMF) has been issuing an annual report monitoring the activities of CRAs since 2005.

Second, the Commission was also lukewarm towards the prospect of regulating CRAs in the EU and hence did not put forward legislative proposals (interviews, Brussels, May 2007). As pointed out during several interviews with policy-makers and stakeholders, the 'better regulation' approach of the Barroso Commission was often in line with the policy preferences of the Anglo-Saxon coalition, promoting 'light touch' regulation. Third, no EU presidency forcefully pushed this matter. Last but not least, there was strong opposition to EU rules from the main stake holders in the private sector, namely the CRAs, which held considerable bargaining power given the oligopolistic nature of the rating market.

Following the Parmalat scandal, a resolution of the EP (2003) and a report of the EP (EP 2004), the EP called on the Commission to produce an assessment of the need (if any) for legislative intervention in this field. In July 2004, the Commission asked the CESR to provide technical advice on this. The CESR concluded that overall, the substance agreed by the IOSCO Code that was issued in the meantime addressed the issues raised by the Commission's mandate (CESR 2005a, b). In line with the 'better regulation' approach adopted by the Barroso Commission and fully subscribed to by the Internal Market Commissioner Charles Mccreevy, no legislative proposal was put forward by the Commission at that stage (Commission 2006). The Commission asked CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis.

In September 2007, when the sub prime-scandal in the US was in full swing, the Commission asked the CESR to review the role of CRAs in structured finance and re-evaluate regulatory options in this area. The 2008 CESR report on CRAs, like the 2005 CESR report, continued to support market driven improvement, considering the IOSCO Code, which had been revised, as the standard to regulate CRAs (CESR 2008). A second report commissioned by the Commission to the ESME[5] also concluded against the introduction of legislation in the EU. Echoing the concerns of the CESR, the ESME concluded that 'Given the global nature of the business of CRAs and the existing US law, we have doubts as to whether the development of a separate EU law would produce any particular benefits. We think it is important that CRAs are subject to a global approach to their business… regulatory coop-eration in this sphere is essential to avoid duplication of effort' (ESME 2008).

Notwithstanding the negative advice of these two expert bodies, the global financial crisis had tipped the political dynamics in favour of EU legislation on CRAs. The French presidency of the EU in the second semester of 2008 implicitly made EU legislation on CRAs one of its priorities in elaborating the regulatory response to the global financial crisis (interview, Paris, May 2009; Madrid, March 2009; Lisbon, November 2008). The ECOFIN Council in July 2008 supported the overall objective of introducing a strengthened oversight regime as well as the principle, put forward by the Commission,

[5] ESME had been set up in April 2006 as an advisory body to the Commission.

that CRAs should be subject to registration in the EU (Council 2008). The European Council called for a legislative proposal to strengthen the rules on credit rating agencies and their supervision at EU level in October 2008 (Presidency conclusion 2008). Influential MEPs also supported the regulation of CRAs in the EU (*Financial Times,* 8 July 2008. p.3). Indeed, the EP produced two own initiatives reports that discussed this matter (EP - Rasmussen 2007; EP - van der burg and Dăianu 2008).

In July 2008, the European Commission published two consultation papers concerning: a) a complete regulatory framework for CRAs (Commission 2008b), which included the draft proposal for a directive or regulation on CRAs (at that time the legislative format of the proposed EU rules had not yet been decided); and b) policy options to address the problem of excessive reliance on ratings (Commission 2008c). The Commission's draft viewed the revised IOSCO Code as the 'global benchmark' in terms of substantive requirements, but it argued that these rules needed to be made more concrete in some cases and to be backed by an enforcement system. Many of the proposals articulated by the Commission at this stage were retained into the official proposal for legislation, hence they are discussed in the following section. Here it is important to note that the Commission outlined two alternative and hotly debated schemes concerning the allocation of supervisory competence, as elaborated in the following section.

After the public consultation, the Commission redrafted the document, coming out in favour of one of the two supervisory models outlined in the July document and moving some controversial technical details into annexes. It should be noted that after the adoption of the regulation, the annexes could be amended through the Lamfalussy 'comitology' procedure, which is designed to simplify the process of amendment. The Commission officially proposed the draft regulation in November 2008.

In March 2009, the Committee of Permanent Representatives (COREPER) agreed on the proposed regulation, followed by the endorsement of the ECOFIN Council. The EP did not propose major amendments to the text with the exception of the allocation of responsibilities for registration and oversight and the issue of extra-territoriality. The rapporteur, Jean-Paul Gauzès and the members of the Committee for Economic and Financial Affairs of the EP, proposed that CESR – and not the national competent authority of the home member state - should be responsible for registration, authorisation, notification and decision to withdraw registration.[6] The EP report drew attention to the international dimensions of the activity of CRAs, and hence the need to envisage provisions for regulatory equivalence with other non EU jurisdictions (first and foremost the US), as discussed in the following section.

[6] The de Larosiere Group (2009) made a similar point.

7. The content of the EU regulation on CRAs and the most controversial issues

According to the regulation eventually approved in April 2009, all CRAs whose ratings are used in the EU need to apply for registration through an application submitted to the CESR and jointly decided upon by a college of securities regulators. The college of regulators is also involved in the day-to-day supervision of CRAs. Registered credit rating agencies have to comply with rules designed to prevent conflict of interest in the rating process and to ensure the quality of the rating methodology and the ratings. CRAs operating in non-EU jurisdictions can issue ratings to be used in the EU provided that their countries of origin have a regulatory framework recognised as equivalent to the one put in place by the EU, or that such ratings are endorsed by an EU-registered CRA.[7]

There were four contentious points concerning the content of the EU regulation on CRAs. To begin with, there were the issues related to the competent authorities in the process of registration (authorization, monitoring/oversight, cancellation). The Commission's consultation document issued in the summer of 2008 proposed two alternative models, on which policy makers preferences were very much divided.

The first model prescribed the allocation of supervisory competences to the home competent authority. The involvement of the other competent authorities - the host competent authorities - was left open, though they would be entitled to recover their national competence in case of inaction or ineffective action of the home competent authority. This model was largely supported by the countries likely to be home countries, first and foremost the UK, as suggested by the response of the British Treasury to the Commission's consultation,[8] whereas it was regarded as somewhat unsatisfactory for the host countries (interviews, Lisbon, November 2008; Madrid, April 2009). One of the disadvantages of this model was the risk of diversity of application of EU law at the national level.

The second option combined the establishment of an EU Agency (the CESR or a newly created agency) responsible for authorization, whereas the home country authorities would be responsible for ongoing supervision. Amongst the vast majority of member states and within the CESR, there was little support for the creation of a new agency (CESR 2008b). Furthermore, countries traditionally wary of strengthening EU

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[7] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/629&format=HTML&aged=0&language=EN&guiLanguage=en

[8] All the responses cited in this section can be found at: http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/credit_agencies&vm=detailed&sb=Title.

institutions, including the Lamfalussy committees, first and foremost, the UK (see Her Majesty's Treasury 2007), opposed a stronger role for the CESR.

Why was the allocation of power of authorisation and oversight so controversial? This was because, since the main CRAs are not European, if one considers factors such as their number of employees or size of operations in the EU, these agencies are based in London. Hence, the British Financial Services Authority would have the main role in supervising their activities in the EU (interviews, Lisbon, November 2008; Madrid, April 2009). However, this raises the thorny issue of the relationship between home supervisors and host supervisors, which is traditionally a bone of contention in the regulation of financial services in the EU (Quaglia 2008). One important difference as compared to the banking sector, is that countries such as Germany, Italy, Spain, Netherlands and Belgium, which are home supervisors for banks operating throughout Europe, would fit into the category of host supervisors of CRAs, which have their European headquarters in London.

The second controversial issue concerning the content of the EU regulation on CRAs was that several substantive provisions put forward in the initial Commission's regulatory approach were regarded as too detailed. For example, it required the competent authorities to gather information about the model used by CRAs, the quality of people employed etc. This criticism was articulated in particular (but not only) by countries that have traditionally been in favour of light touch, principle-based regulation, as evidenced by the response to the Commission's consultation of the British Treasury, the Swedish Finance Ministry, the Finnish Finance Ministry and by the main CRAs that took part in the consultation, namely Standard & Poor's, Moody's, Fitch, AM Best. Some private financial associations, such as the British Bankers Association, also expressed their support for principle-based legislation.

The criticism concerning the prescriptive nature of the Commission's proposal was also shared by several members of the CESR, regardless of their nationality, because national supervisors were worried about the practical implementation and enforceability of the rules proposed (CESR 2008b). As one interviewee put it, the initial Commission's proposal was 'Soviet style' (interview, Lisbon, November 2008). Moreover, the main CRAs (Standard and Poor's, Moody's, Fitch, AM Best), felt that some provisions would restrict the analytical independence of the CRAs for their ratings. They argued that EU rules should not regulate the substance of credit ratings and the methodology used by CRAs, but rather the principles and process that a CRA undertakes to generate a proper rating. This was also stressed by the British and Dutch finance ministries, as well as the committees of supervisors, CESR and CEBS.

Thirdly, and related to the previous point, there were some differences between the rules proposed by the Commission, the SEC rules and the IOSCO Code. On several issues, the EU proposal was judged as not being aligned with the US regulation on CRAs and with the IOSCO Code. In their response to consultation, the main CRAs argued that it would be unduly burdensome for CRAs to maintain different policies and procedures only

within the EU to reflect variations made to the IOSCO language. Moreover, differences between EU and IOSCO rules would de facto create new barriers because the main CRAs are based in North America (CESR 2008). It would also lead to the extra-territorial application of requirements dealing with the organization of the agencies worldwide as pointed out by the main CRAs but also by the European Banking Federation, and the American Chamber of Commerce response to consultation.

Notwithstanding the global financial upheaval, and the presence of a critical mass of member states in favour of the regulation in the Council, certain member states, notably the UK, Sweden, Finland, the Netherlands, and some stakeholders (including the European Banking Federation, the Association of British Insurers, the British Bankers Association etc.) continued to oppose EU legislation, preferring instead a global solution, based on enhanced self-regulation and the IOSCO rules. It should be noted that these policy makers and stakeholders generally favour international non-legally biding rules as well as private sector governance in the regulation of financial services, instead of strengthening EU regulatory template (Angeloni 2008). This partly has to do with the fact that they host several non-EU financial institutions in their jurisdiction, as in the case of the City of London. This is partly because, as the Dutch Finance Ministry (2008) put it 'Given the unique characteristics of the credit rating market in which the impact of faulty credit ratings on investors is unrelated to the jurisdiction where the rating activity took place, one could argue that effective supervision is not a national or European but a global issue'.

Last but not least there was the issue of the potential extra-territorial effects of EU rules on CRAs located in third country jurisdictions and the setting up of mechanisms to ascertain the equivalence of rules. According to the initial Commission's proposal the CRAs with headquarters outside the EU but which wanted to operate in the Community were required to set up a subsidiary in the EU which could then be registered by the competent authority. A CRA registered in one member state could issue credit ratings anywhere in the EU, de facto setting in place a passport for CRAs across the EU.

However, many policy-makers (the EP was vocal on this, see EP 2008, 2009) felt that a mechanism was needed to recognise certain third country regulation of CRAs as 'equivalent' to the EU, with a view to facilitate the use in the EU of the ratings issued by CRAs located outside the EU. After quite extensive lobbying, first and foremost by the British authorities, which were worried about the negative effects that this could have for the financial instruments traded in the City of London (House of Commons 2009), the regulation agreed in April 2009 contained provisions for an equivalence mechanism to be operated by the Commission. Nonetheless, some concern remained about the potential extra-territorial effects that the provisions regarding the internal governance structure of CRAs could have on the headquarters of the CRAs whose subsidiaries were located in the EU.

8. An overall assessment

So, why was the EU able to pass relatively quickly brand new legislation on CRAs, despite some unsuccessful past attempts and instead of relying on the revised IOSCO Code and the revised US law? The exogenous shock of the global financial crisis led to a new institutional outcome (or equilibrium), namely the creation of EU rules on CRAs, through three causal mechanisms. First, it triggered a functionalist response to the crisis: the existing regulation had patently failed, as evidenced by the crisis, thus the regulatory framework needed to be revised worldwide – and so it was. This causal mechanism had a global reach, hence it does not explain specifically why the EU decided to adopt its own rules on CRAs.

Second, the global financial crisis strengthened the bargaining power of policy-makers that had long been in favour of regulating CRAs in the EU. It opened a 'window of opportunity', which certain policy-makers, first and foremost France, which held the rotating presidency of the EU, were able to exploit, acting as 'policy entrepreneurs' (Kingdon 1984). Whereas France had long been in favour of regulating CRAs in the EU, other member states that in the past had not been very vocal on this matter came out in favour of legislation after the global financial turmoil (interviews, Paris, May 2009). This made it possible to have a critical mass supporting EU rules in the Council. Given the changed context, the Commission decided to propose legislation to regulate CRAs.

Some member states, first and foremost the UK and Netherlands, continued to oppose EU rules, favouring instead the voluntary compliance with the revised IOSCO Code. However, the light touch, soft law regulatory paradigm successfully articulated by the Anglo-Saxon coalition over the previous decade and to some extent embraced by the Commission in the regulation of financial services (Quaglia 2009) was very much in disrepute as a result of the financial crisis. This weakened the bargaining power of this coalition, silencing their opposition to EU rules on CRAs. The financial crisis also weakened the position of the CRAs, which understood that the opportunity structure in the EU had changed in favour of EU regulation (interview, London, June 2009). Thus, they mainly engaged in the debate about shaping the new rules, rather than opposing them altogether.

Thirdly, the global financial crisis somewhat increased the international bargaining power of the EU in the global regulatory arena and in the regulatory debate vis-a-vis the US. The strengthening of the EU voice in this fora had began to take place prior to the crisis, largely following the relaunch of the completion of the single market in financial services (Posner forthcoming). In the case study under consideration, this emerging trend was reinforced by the fact that the US regulation of CRAs had showed significant flaws that fuelled the financial crisis. This emboldened EU policy makers (at least, a critical mass of them) to set up an EU regulatory framework alternative to US law on CRAs. The EU moved from being a 'taker' to being a 'maker' of international rules. Indeed, in the US,

where the reform enacted by the SEC in early 2009 is judged by some as not going far enough, there are calls for the US to 'follow Europe's tougher rules' (Wharton 27 May 2009).

Conclusions

Regulating the activity of CRAs very much highlights the multi-level governance of financial services and the 'uploading', 'downloading' and 'crossloading' of rules across jurisdictions and levels of governance (international, EU and national). First, at the international level, the activity of CRAs has been regulated by the IOSCO through the Code of fundamentals on CRAs, issued in 2006 and revised in 2008. The rules of such a code have to a large extent been downloaded into the proposed EU legislation, albeit there were important provisions that were specific to EU legislation.

Second, in 2006 the US passed legislation on CRAs, which has been revised in 2009, partly downloading the revisions of the IOSCO Code. This in turn raises issues about the extra-territorial effects of US rules for CRAs operating in Europe and the prospect of an indirect downloading (or crossloading) of such rules in the EU. Third, there are the potential extra-territorial effects of the proposed EU legislation because the main CRAs are headquartered in North America and operate in Europe mainly through subsidiaries. This raises the prospect of an indirect uploading or crossloading of the new EU rules in non-EU jurisdictions, first and foremost the US.

In the multi-level governance of financial services the EU is emerging as a *regulatory power* in the aftermath of the global financial crisis. This paper accounts for this by using a soft RCI framework to explain the impact of this exogenous shock in changing actors' bargaining power in the regulatory process within and without the EU. It also teases out the causal mechanisms through which this has affected the institutional outcome, namely the regulation on CRAs in the EU. The crisis empowered the pro-regulation coalition of policy-makers in the EU, which had long called for the regulation of CRAs, weakening the coalition that favoured light touch regulation and was mindful of the potential implications of EU rules on international financial markets. This also suggests that the global financial crisis did not substantially change the preferences of the main policy-makers, though it did alter the balance of powers within the EU and vis-à-vis the US.

The explanatory framework proposed in this research could be applied to the regulation of other financial services in the EU and to explain the regulatory wave engineered by the EU in the wake of the global financial crisis. For example, in May 2009 the Commission proposed (controversial) legislation on alternative investment funds, which, like CRAs, operate in a multi-level regulatory space.

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Research design

T0: before the financial crisis, T1: after the financial crisis