

Brief Analysis on Conflicts of Interest of Credit Rating Agencies

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Abstract

With the outbreak of the current US financial crisis and European sovereign debt crisis, the current credit rating system has indicated various problems, and especially the conflicts of interest are becoming more and more obvious. Based on the issuer-pays mode, this article analyzes the causes of such conflicts of interest from the angle of regulation of fiduciaries, including international regulation, and puts forward suggestions on solution of such conflicts.

Key words: Rating agency; Conflicts of interest; Fiduciary; Regulation

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The role of credit rating agencies as “gate keeper” of the market has been challenged since the occurrence of the subprime mortgage crisis in 2008. Those agencies gave virtual high ratings on subprime mortgages and such structured financing products as CDOs, which accelerated the burst of subprime mortgage bubble and the crisis. After the outbreak of the crisis, those irresponsible agencies considerably lowered the ratings of such kinds of products, which resulted in market panic and increasing

market fluctuations, which in turn led to the formation of the “procyclical effect” of financial crisis, and spread of the subprime crisis (Krugman, 2010). Why did the function of rating agencies as the “gate keeper” of market fail to work? Though we may not attribute all liabilities for this crisis to those agencies, what was shown in the crisis, for example, moral hazard and conflicts of interest, does disable such agencies to keep their objectivity and independence. Especially, the conflicts of interest are the main cause for loss by rating agencies of their independence.

1. EVOLVEMENT OF CONFLICTS OF INTEREST¹ OF CREDIT RATING AGENCIES

The credit rating industry emerged after Moody’s conducted the primary credit rating on railway bonds in 1909. At the beginning, credit rating was for free, which lasted until the year of 1968 when the top three credit rating agencies collected charges from investors for the information related to credit ratings they provided. At that time, thanks to single kind of clients and financial products of credit rating agencies, there were almost no conflicts of interest. However, such charging mode easily generated “free-riders” and moral hazards. Moody’s and Fitch Ratings started to collect charges from issuers after 1968; in other words, securities issuers should pay credit rating agencies for credit ratings on their securities. Currently, the charges paid by issuers account for most part of the revenues of main credit rating agencies. The documents of SEC’s hearing on November 21, 2002 indicated that 90 percent of the revenues of Moody’s was from credit rating charges paid by issuers and the remaining 10 percent from research and data service it provided; similarly, among the

¹ Conflicts of interest means when serving two or more interest groups, an agency may sacrifice the interest of one group for more gains of the others; or there are conflicted interests between a service provider and its clients. What we discuss here refers to the first meaning.

revenues of Fitch Ratings, 90 percent came from issuers and about 10 percent from payment by investors (YING & ZHANG, 2006). In such issuer-pays mode, credit rating agencies play two roles as the “issuers’ seller” and the “investors’ agent” at the same time, who collect charges from the entities to be rated while disclosing securities risks to investors. In such way, the original principal-agent relationship is distorted and the potential of conflicts of interest rises.

Since credit rating on bonds relates to issuers, investors and regulators, who may have different interests, and credit rating agencies also play different roles, when their interests are inconsistent in certain situations, conflicts of interest may be inevitable (NIE, 2011). The working mechanism of conflicts of interest in the issuer-pays mode is as follows:

A credit rating agency collects data and information for detailed investigation and analysis on an entity to be rated; → the credit rating agency determines the credit rating of the entity; → the credit rating agency releases the credit rating on the entity to investors; → investors decide whether to invest in the entity based on the credit rating at their own discretion and regulators supervise the entity based on the credit rating; → the investment of investors impacts the financing scale and cost of the entity; → the credit rating agency receives credit rating charges from the rated entity (as well as the fees paid by some investors for journals published and provided by the credit rating agency) (LI, LI & Shao, 2009).

In such a pay mode, credit rating agencies serve three interest groups -- issuers, investors and regulators, whose interest conflicts. Specifically, the value of credit rating agencies for investors and regulators lies in their provision of an accurate and reliable rating to disclose credit risks of different financial products; while for issuers, credit rating agencies imply they are able to give them the “access permit” to capital market. Usually, credit rating agencies sacrifice the interests of investors and regulators to meet the needs of issuers in rating.

The revenue of credit rating agencies in the issuer-pays mode is mainly from issuers and the intent of issuers to pay those agencies depends on whether they may be granted a satisfactory rating (XU, 2011). Accordingly, the pursuit for economic benefits and market share is enough to motivate credit rating agencies to give higher ratings on the securities of issuers. Based on what analyzed above, there are conflicts of interest among issuers and investors and regulators in the issuer-pays mode. Since the intervention of media is a necessary factor for sharpening of conflicts, we may analyze the causes for such intensification in two respects.

2. CAUSES FOR CONFLICTS OF INTEREST OF CREDIT RATING AGENCIES

The US Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (hereinafter referred to as the Dodd-Frank Act) provides: credit rating agencies shall be subject to the “expert liability” as applied to auditors and securities analysts. As “gate keeper” of the financial market, securities analysts, auditors and credit rating agencies are responsible for providing consulting services to investors, and since they have the duty of a good administrator, they are collectively called “fiduciaries”. Consequently, they shall assume the duty of care and fiduciary duty as “expert liabilities”.

The duty of care is a legal principle derived from cases of common law of Anglo-American law system. According to Oxford Dictionary of Law, it refers to “the legal obligation to take reasonable care to avoid causing damage”. In German scholar Engisch’s opinion, the duty of care shall be discharged in three respects: (1) to restrain from any dangerous acts, that is, prudently avoid any acts that may incur any infringement of legal interests; (2) to take actions at stake, that is, make any action or omission necessary to avoid any damages from any acts that may incur any possible infringement of legal interests; and (3) to discharge the obligation to obey the law, that is, think over the dangerousness of an act to be done and make a correct judgment (Liu, 2002, p. 50-53). The duty of care of rating agencies is mainly as follows: (1) to avoid infringing upon the interest of every party in rating; (2) to observe laws and disciplines; and (3) to remain prudent and objective in rating.

The fiduciary duty is a key concept in trust. In terms of company law, it means that directors, senior officials and controlling shareholders of a company are prohibited from using the resources of the company or its partners to pursue their personal interests. Specifically, first, directors may not get benefits by taking advantages of their positions; and second, directors may neither commit bribery nor take any secret interest or other benefits promised. Accordingly, the fiduciary duty of rating agencies means those agencies may neither pursue their own interest or damage others’ interests nor abuse their power and function to commit bribery.

Fiduciaries shall discharge their duty of care and fiduciary duty. Rating agencies, especially, are required to stick to the principles of objectiveness, integrity and prudence and try their best to avoid conflicts of interest. This subprime crisis, however, reveals that rating agencies abused their power and breached their fiduciary duty in rating, which brought huge damages to investors. Breach by fiduciaries of their duties is considered as the main cause for intensification of conflicts of interest of rating agencies.

2.1 Fiduciaries' Breach

Based on the issuer-pays mode, breach by fiduciaries of their duty of care and fiduciary duty is manifested as follows.

Firstly, in terms of charge payers, rating agencies adopting the issuer-pays mode are likely to be lured. For instance, the investigation findings of US Senate released in 2010 stated by quoting an email of an employee of Standard & Poor's that "it is necessary to hold meetings to discuss adjustment of the rating standards for mortgage-related securities to avoid loss of our clients"; and in another email, this employee complained that "we have to color subprime and Alt-A mortgages to keep our market share" (Feng, 2010, p.6). There is the possibility that rating agencies fail to discharge their duty of care as fiduciaries and give false high ratings to issuers at the cost of investors' interest due to economic considerations.

Secondly, in terms of charging standards, rating agencies collect pro rata charges according to financing size. Usually, such charges equal to 0.2-0.3 percent of the income from issuance mainly based on the size of issuance and complexity of business (Chen, 2009, p.53). For a securities issuance, a high rating may reduce the cost of an issuer and contribute to the success of issuance; hence, a higher rating requires higher charges. Though such false ratings increase the proceeds of issuers and rating agencies, they damage the interest of investors. In such situation, rating agencies breach their fiduciary duty as fiduciaries since they pursue their own benefits at the expense of others.

Thirdly, in terms of persons performing ratings, they often have direct or indirect relationship with the entities to be rated, for example, by holding any security of such entities, serving as a part-time worker of those entities, especially as senior officers (for instance, Clifford L. Alexander, Moody's former president, once served as the president of WorldCom for 19 years and when the rating on WorldCom by the market lowered to below investment grade, Moody's rating on it remained above investment grade) (Chu, 2011, p.73-76), or committing bribery. As a result, the objectiveness of rating results is in question.

From the aforesaid analysis, it may be said the main cause for intensification of conflicts is the collusion of rating agencies and issuers, which damages the interest of investors and makes rating agencies lose the accuracy, independence and objectiveness of their ratings.

2.2 Lack of Effective Regulation

Credit rating agencies always enjoy a special status in law. If the breach by rating agencies as fiduciaries in the issuer-pays mode is mainly ascribed to the conflicts of interest, the lack of effective legal regulation may be the catalyzer.

Firstly, the regulation of conflicts of interest fails to touch the core issue. The IOSCO's CRA Code of Conduct 2004 requires, with respect to independence and management of conflicts of interest, that rating

agencies and analysts maintain procedural and substantive independence and objectiveness and the key elements for rating shall be risk-related factors. However, it does not mention the core issue of linkage between charging standards and rating grades. In addition, though it launches several measures for regulating rating, the Dodd-Frank Act does not make explicit provisions on the key issue of conflicts of interest of rating agencies, but only requires the controller general to explore an alternative business mode for rating agencies' charge collection and submit a report within 18 months after implementation of the Act. Therefore, there is still no law to deal with the regulation of conflicts of interest of rating agencies so far.

Secondly, rating agencies are usually exempted from legal liabilities. In the course of bond rating history over 100 years in the US, there were only two cases concerning lawsuit by investors against rating agencies, and even if those agencies were prosecuted, they were decided to bear few liabilities finally (Zhang & Tan, 2011, p.29-33). It is because credit rating agencies are protected by exemption provisions of the Second Amendment to the Constitution of the USA and Section 11 "Civil Liabilities on Account of False Registration Statement" of the Securities Act of 1933, as rating results are legally deemed as an "opinion", which is of no legal force but only for reference by investors (Fang & Liang, 2011, p.85). Unless rating agencies have any purposive behaviors in rating, they may not take any legal liabilities. Though the Dodd-Frank Act provides for the expert liability of rating agencies, saying that investors may lodge a private lawsuit against credit rating agencies if they "knowingly or recklessly failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk", there is still a long way for investors to safeguard their legitimate rights.

Thirdly, the top three credit rating agencies make monopoly and lack regulation. Though those agencies are incorporated as non-government organizations in name and boast "accuracy, independence, objectiveness and prudence", there is a game of various interests. Basically, those international credit rating agencies mainly stay in a primitive situation where US regulators have the say. For instance, US regulators prescribe that unless it obtains a rating report from one or even two recognized credit rating agencies, an issuer may be not be permitted to issue its bonds, but who is a recognized credit rating agency is totally subject to such regulators.

3. SUGGESTIONS ON REGULATION OF CONFLICTS OF INTEREST

As conflicts of interest of credit rating agencies root in the issuer-pays mode, such mode shall be reformed to reduce conflicts. Since the financial crisis, how to make a reform

in the credit rating industry has been frequently discussed by scholars and experts. Facing the existing charging mode, some scholars have questioned the reasonableness of existence of rating agencies and others proposed an investor-pays mode. The SEC also held a round-table conference on April 15, 2009, in which then Chairman Schapiro advised rating agencies to adopt new business mode to take investors as the final clients and hence make their interest consistent with investors. A government-pays mode was also proposed with a view to effectively solving the conflicts of interest.

We believe, firstly, the credit rating industry has proved the reasonableness of its existence through its long development. It has become an important part of the capital market and is capable to reduce information asymmetry; therefore, it plays a significant role in the financial market. Secondly, to adopt the investor-pays mode is unreasonable, since such mode easily leads to “free riders”, which may bring adverse impacts on the industry in a long term. Finally, the government-pays mode is improper, as government is also the issuer of some bonds and such mode may generate conflicts of interest and even corruption.

Though scholars and experts have been discussing different pay modes, the existing one cannot be replaced in a short time. Therefore, we hold that emphasis shall be placed on regulation of conflicts of interests when exploring new modes. Legislative measures for the charge collection system may be adopted to avoid conflicts of interest in respect of institution and executor.

3.1 Enhancement of Regulation on Fiduciaries and Improvement of Internal Governance of Rating Agencies

As fiduciaries, credit rating agencies is expected to maintain independence and objectiveness in credit rating. This subprime crisis and European sovereign debt crisis, however, revealed those agencies’ ineffective internal policies on prevention of conflicts of interest and poor procedural execution and breach of their fiduciary duty. Thus, the fiduciary regulation shall be strengthened and the internal governance of rating agencies shall be improved.

Firstly, fiduciary regulation shall be enhanced. Rating agencies, as fiduciaries, bear the duty of care and fiduciary duty to investors and issuers and shall conduct an equal and objective credit rating and may not damage the interest of any party, but actually, they did breach their duties and sacrificed the interest of investors. Why? It is because there is no effective regulation and punishment. We believe we may, by reference to the practice and experience of financial intermediaries including auditors and securities analysts, work out criteria for career management of credit raters and supervise the professional activities of credit rater. Such criteria may be legally promulgated to be of mandatory force and

those who violate the criteria may be subject to legal liabilities. Or we may have a try to make observance of those criteria by credit raters as part of their yearly performance assessment and link it with their incomes. Due to our knowledge limitation, specific methods need to be discussed separately.

Secondly, an independent director system shall be established. At least half of members of the board of a rating agency shall be directors independent from the agency and the number of such directors shall be no less than two. Independent directors shall include users of the rating results and they may not receive any consulting fees or other compensations from the rating agency they serve. Those who associated with the rating agency or its affiliated organs shall be deemed disqualified for an independent director. Meanwhile, when an independent director has any interest in a rating, he/she may not participate in such rating. Moreover, the compensation of independent directors may bear no relationship with the performance of the rating agency.

Thirdly, the conflicts of interest arising from marketing shall be eliminated. Credit rating agencies are advised to establish and execute a “firewall system” to separate marketing personnel from those who engage in rating analysis to avoid any influence on objectiveness of rating. In case of failure of rating agencies to carry out such system, competent authorities may impose severe punishment like revocation of their license on them. Furthermore, rating agencies may make a reform of their compensation system, unlink compensation and rating grade, and set up a sound system to avoid conflicts of interest.

3.2 Strengthening of Legislative Regulation

Loose regulation is considered as an objective cause for rating agencies’ loss of their independence and objectiveness. Consequently, strengthening legislative regulation is always the focus of regulation in the industry. Though the Dodd-Frank Act of 2010 provide regulation rules for rating agencies in 9 parts at institutional and legal level, we hold it is insufficient and the following aspects may be incorporated in legislation.

Firstly, the nature of rating results is legally ambiguous. Since rating agencies are considered as publishers or underwriters in the US, rating results are only deemed as opinions, comments or goods, which exempt rating agencies from legal liabilities. There in no legal liabilities of rating agencies in US’s legal system, though Dodd-Frank Act provides that rating agencies shall be subject to legal liabilities and public regulation in the similar way as apply to auditors, securities analysts and investment banks. The Act abolishes Rule 436 (g), which means rating agencies have to bear the expert liability as specified in Section 11 of the Securities Act of 1933. However, this provision only clarifies the liabilities of rating agencies, but not indicates the legal status of

rating results. The nature of rating results shall be legally identified to clarify legal liabilities concerned.

Secondly, Dodd-Frank Act provides that rating agencies shall bear “expert liability” and adds private right of action, saying that “in the case of an action ... it shall be sufficient ... that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk”. But what causes may be used by investors and who may take the burden of proof?

We believe that such cases may be dealt with as infringement, since there is causality among rating agencies’ breach, existence of knowing or reckless conduct, damages incurred to investors due to rating results, false rating results and loss to investors, which are constituents of an action of infringement.

As to burden of proof, we hold that though according to general tort theories, the burden to prove financial loss of investors and false rating results shall be taken by plaintiff, it is very difficult to let investors as the plaintiff to provide evidences in judicial practice. To reduce burden of proof and protect investors, rating agencies may be required to prove the objectiveness of their rating result, which is derived from analysis of different information, and that the loss to investors does not caused by their reliance on rating results, or the rating agencies may assume the legal liabilities for loss of proceedings. Article 173 of the Securities Law of China provides that where a securities service agency formulates and generates any auditing report, asset appraisal report, financial advising report, credit rating report or legal opinions for securities business activities, it shall be diligent and responsible...In the case of any false record, misleading statement or material omission in such documents, which brings any loss to any other person, the securities service agency shall bear the joint and several liabilities together with the relevant issuer and listed company, unless it may prove it has no fault. Actually, those provisions stipulate the legal liabilities of credit rating agencies, but they are only provisions in principle, irrelevant to regulation of conflicts of interest. Consequently, we hold the legislative regulation on burden of proof in actions involving conflicts of interest of rating agencies shall be further enhanced.

Finally, as to the monopoly of top three credit rating agencies, it is suggested to develop local rating agencies. For example, the EU is enthusiastically creating their own credit rating agencies to end the monopoly of the top three agencies. As far as the role of credit rating agencies in global economy is concerned, credit rating agencies are imbued with strong political overtones and often abuse their special position to seek for their national

interest. Since credit rating agencies are expected to be immune to political influence and become an independent “gate keeper” of the financial industry in a real sense, we believe we may reinforce global financial cooperation to set up a super-national credit rating agency adopting the membership system, the ratings made by whom will be of public confidence force, and branches may be established in member countries.

CONCLUSION

In China, due to late start of the credit rating industry, corresponding regulation framework and systems are simple, but with the improvement of the financial system, the business scope and functions of credit rating have been considerably expanded. Facing increasing conflicts of interest arising from the issuer-pays mode, more provisions on credit rating have been promulgated by different departments. For example, Article 41 of the Interim Measures for Administration of Credit Rating Business in the Securities Market by China Securities Regulatory Commission provides that “where a securities credit rating agency contravenes the challenge system or the prevention system of conflicts of interest, it may be ordered to make a correction, warned, and imposed penalties equal to the amount of more than RMB 10,000 and less than RMB 30,000; the officials and other employees who bear direct responsibilities shall be warned and imposed penalties equal to the amount of more than RMB 10,000 and less than RMB 30,000. In any severe situation or in case the credit rating agency refuses to make a correction, it shall be punished in accordance with paragraph 3 of Article 226 of the Securities Law”. However, such legal documents, at a low level and without a system, contain inconsistent provisions, which are only made in principle, less mandatory and punitive. As a result, we may, by reference to the legislation of developed countries on credit rating, establish a sound special legislation on credit rating, especially creating a special section for regulation of conflicts of interest.

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