

Credit Rating Regulatory System of Foreign Countries and the Enlightenment to China

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Abstract:

In recent years, with the continuous development of the credit rating industry in our country, the voice of building the rating regulatory system is sprouting up. This article introduces the rating regulatory system of the United States, Japan and the European Union. According to the experiences and lessons from developed countries such as America, to solve the immature legal system of rating industry, lack of unified qualification recognition mechanisms and other issues, we need to improve the legal system, unified standards, strengthen the regulation of rating markets and institutions, formed a credit rating system, which contains the government management, self-discipline and social supervision.

Key words: Credit rating; Legal system; Approval system; Regulatory agencies

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INTRODUCTION

Credit rating industry is a special intermediary service in the financial system, known as “financial police”, “capital market watchdog”. In the dynamic cycle of the game process of “Financial Innovation--Financial Risk--Financial Regulation--Financial renovations”, it plays an irreplaceable

role in improving market efficiency, enhancing information exchange stock market, and help investors reduce the information searching costs, etc. With accelerating economic globalization, the rapid development of the bond market, the credit rating industry is also showing leaps and bounds. Now the international capital market has basically formed the three leading major U.S. rating agencies, some local credit rating agencies led their own markets pattern.

In the first decade of the new century, the global financial crisis, the Dubai debt crisis and the Greek sovereign debt crisis triggered by the subprime mortgage crisis not only revealed that the current international credit system exists some defects and confusion, but also exposed the rating industry self-regulation failure and market mechanisms, it's hard to guarantee the rating agencies' independence and rating quality, and even rise a worldwide discussion on strengthening the credit rating regulation (ZHENG, 2012). After go through the problem of credit rating agencies, the United States and the European Union proposed and implemented a number of reform programs and measures, the core ideas can be summarized as follows: strengthen the credit rating agencies' role as information and monitor, weaken its certification role, namely improve the legislation, strengthen the supervision of rating agencies to reduce interest conflicts, promote competition among the credit rating industries and reduce excessive dependence on external credit ratings (Research team, 2012).

A country's credit rating regulatory system can be divided into two levels: the national level and community level. By improving the legal system, a clear regulatory objective, content regulation, supervision and regulatory rights of way, a country can promote the credit rating industry shift from self-regulation to the direct supervision and registration access. The level of community supervision include: self-discipline industry oversight, internal management rating agency, the rating market supervision.

Owing to the differences in economic development, political environment and rating markets, each country's

credit rating regulatory system is different. The formation of industry self-regulation such as the US based on nationally recognized statistical rating organization (NRSRO) registered with the US Securities and Exchange Commission (SEC) based on 2006 “direct supervision credit rating agency reform bill”, conducted by a combination of credit rating regulatory system (E & ZHOU, 2012). In Europe, the European Commission still uses IOSCO Code of Conduct for financial services directly and self-regulatory approach, and tended by the bank regulatory agencies responsible for credit rating oversight bodies under “the Basel II”.

Our credit ratings produced in the late 1980s, it is still a sunrise industry. Based on the multiple factors such as the absence of government, the market vacancy and the law, the credit rating industry has been in a disorder competition, less competitive, nonstandard status. Interpretation, reflection, draws America. It is of great significance on researching Europe credit rating regulatory system; it can help China to establish a rating regulatory model.

1. U.S. CREDIT RATING REGULATORY SYSTEM

The United States is a pioneer in the international credit

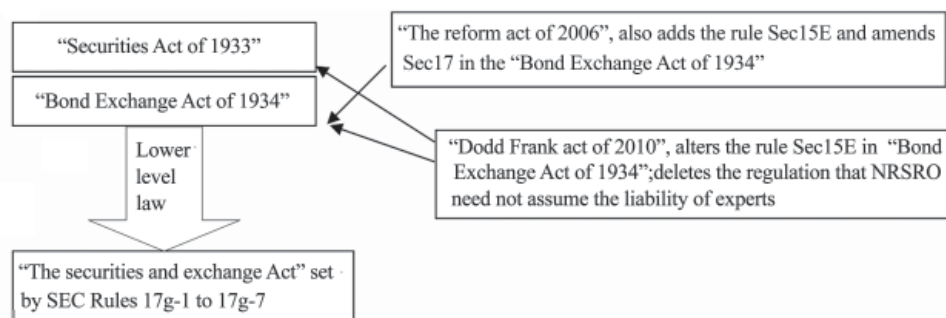


Figure 1
The Legal Supervision System of USA Credit Rating Agencies (CHEN, 2010)

1.2 Accreditation System (NRSRO) To Promote Development of Credit Rating Industry

In 1975, the United States began the rating agencies qualification; rating agencies get recognized called NRSRO. Recognized regulatory regime created a precedent for the U.S. rating, it is widely used by SEC rely on credit ratings of all the rules. As SEC issued a rule of money market fund regulatory (Rule 2a7) in 1996, regulated that money market funds can only be invested in high quality short-term financial instruments, and use NRSRO ratings as a result of the standard portfolio. As the U.S. government and regulators increasing emphasis on NRSRO rating results, making “the original voluntary rating” evolved into “mandatory rating”, the rating industry comes to continuous development. After the NRSRO system introduced, indirectly raises the threshold of entering the ratings market, the past free competition in the market became the three major rating agencies

rating; in 1909 John Moody’s ratings on the debt of American Railroads opened the prelude to modern credit rating. After nearly a century of business development and regulatory practice, the United States has accumulated an abundant of experience on rating, and established a sound regulatory system rating.

1.1 Improve Legal Supervision System of Rating Agency

Before 21st century American rating agencies were driven by “market discipline reputation capital”. Until Enron event, the U.S. began to realize the necessity of legal regulation. In September 2006, “the credit rating agency reform bill” opens the issue of legislation to regulate rating agencies precedent. Afterward, the United States follow the idea of “research-Congress introduced the basic legal- regulatory regime under the authority of the specific implementation rules-according to the practice further legislative changes”, began to build the legal framework for regulation of credit rating agencies step by step. Currently, The U.S. rating agency regulatory system is mainly composed of federal law, form the structure of the upper and lower two layers. Figure 1 presents a current U.S. rating agency regulatory legal system.

dominated by oligopolistic markets. However, the NRSRO system bodies identified still lack of regulation.

2. JAPAN’S CREDIT RATING REGULATORY SYSTEM

In the 1970s, Japan continued to weak the role of the bank, the bond market had been developed, and therefore the credit rating industry burgeoned. The credit rating is a completely “exotic” for Japan, so learning and introducing the operation mode and system design from the US rating industry became the main way to construct a credit rating system of Japan. The Japanese government believes that, the establishment and development of rating agencies, mainly depends on market factors, the government should reduce the intervention on the rating industry. Until June 2009, Japan adopted “The modified act of financial

transactions”, formed a clear legal regulatory model for the first time, its main regulation system:

2.1 Non-Mandatory Registration System for Rating Agencies

The system contains two contents; one is to establish the control system of registered agencies. The system increases the special regulation of registered the rating agencies, such as regular submit the business report to regulators, formulate and promulgate the rating system, accept the supervision of regulators and rectification according to regulatory requirements. Two is to strengthen the results using of nonregistered rating agencies. The bill allows unregistered rating agencies to publish ratings results, but banks, securities companies and other financial institutions must inform the customer rating results from nonregistered rating agencies in the sale of financial products. This clause and its regulation approach with European and American standards (ZHAN, 2010).

2.2 Designated Rating Agencies System

DRAS is developed on the basis of the US NRSRO system, and is the main way to supervise and manage the rating agencies. Compared with the United States, Japanese rating agencies are not qualified in lifetime tenure; the validity of the financial bureau was set up two years, after the expiry date it must return for examination and approval of qualifications.

2.3 Review System

Review system means the same issuer should accept rating from different designated rating agencies at the same time; a local rating agency should be included. As early as in 1989, Japan has made specific provision that issue of general corporate bond should grade by one of the designated rating agencies, convertible bonds and corporate bonds with new booking right issue after rated by two or more agencies. Review system is set up to support and foster domestic rating agencies, although Moody’s and Standard Poor’s enter the Japanese market

for years, the market share of USA is still less than 20%.

3. EU’S CREDIT RATING REGULATORY SYSTEM

3.1 EU Regulatory Model Turns from Self-Regulatory to Direct and Self-Regulatory

Enron event attracted the attention of the EU, the European Commission asked the Committee of European Securities Regulators (CESR) to provide advice on the credit rating agencies in the 2004, and CESR thought that regulatory intervention would stifle innovation and competition, so still insisted on using self-discipline to solve the problem of the rating agencies. While the activities of rating agencies are mainly based on three EU directives: “The market operation instruction”, “The banking Directive”, “Capital Adequacy Directive” and “The basic principles of ethics” established by IOSCO.

The outbreak of the international financial crisis let people witness a massive market failure, people started to oppugn the new liberalism idea, and the government was advocated to use “the visible hand” for intervention and regulation. In this context, the EU formally took regulatory legislation of credit rating agencies on the agenda, the supervision mode evolved to direct and self-regulation.

3.2 Legal Regulatory Framework has been Issued by Scale, Presenting a Unified Regulatory Trend

After the subprime mortgage crisis, the supervision of financial industry turned from national level to pan European level, the rating agencies gradual transformed from self-discipline to unified regulation. “The bill of EU credit rating agencies” established the legal framework of rating agencies, which based on unified registration, and manage the conflicts of interest as the core. The EU improved supervision legal system, through altering rating law. Table 1 presents the development process of US rating regulatory.

Table 1
The Development Process of Rating Regulatory

Period	The first stage 2009.11—2011	The second stage 2011—2013	The third stage 2013— Until now
Feature	The initial formation of regulatory framework	The era of strict regulation	Improve the regulatory rating system
On behalf of regulations	“Regulation I(EC)” No 1060/2009	“Regulation II(EU)” No 513/2011	“Constantly improve the Regulation of credit rating agencies”
The main content	The 1st stage: Territorial jurisdiction and industry access; Right of investigation and supervision department; The management of interest conflict and supervision of rating agencies penalties. The second stage: Strengthen the supervision of sovereign rating; Add the internal rating of financial institutions; Refine the independence of rating object; Firstly propose the civil liability for credit rating agencies		

3.3 Construct Rating Agencies with Pure European Descent, Implement Unified EU Rules

While the EU suffered from the Greek debt crisis, three international rating agencies, Standard & Poor’s, Moody’s

and Fitch turned to “revolt”, frequently reduced the countries sovereign credit rating and bank credit ratings. It made EU to strengthen the supervision height on EU interests and the future of the euro. On June 19, 2009, the

EU summit initiative to establish the financial industry regulatory system for the whole of Europe, and created a secondary institutions in the following year, the agency ensure that national regulators should follow the unified rules of the EU, and is responsible for supervision of credit rating agencies. On April 30, 2010, the EU announced to set up their credit rating agencies, broke the USA oligopoly position in the international credit market.

4. CHINA'S CREDIT RATING REGULATORY SYSTEM

4.1 The Status of China's Current Credit Rating Regulatory

Our credit ratings produced in the 1980s, with the development of economic reform and bond market, the credit rating industry had a rapid development. Until the end of June 2012, the number of legal person institution incorporated in the people's bank of China is add up to 78, more than 2,400 professional staff ratings. China's current regulatory model is based on the credit rating based regulatory regime, leading the central bank regulation combined with auxiliary self-discipline supervision.

From the point of system regulation, State Council promulgated "the Provisional Regulations on Corporate Bond Management" in 1987, opened the curtain of China's credit rating, the People's Bank of China in charge of corporate bond, marked the start of the national regulation of credit rating. In 2006 the people's bank of China issued "the credit rating management guidance", is the first time for the regulatory authorities issued the credit rating industry regulations, the file included credit rating system, the principle of the credit rating, the credit rating process and so on. In 2007, "the Interim Measures for the securities market credit rating services" issued by the China Securities Regulatory Commission, and is one of the most detailed normative documents in credit rating industry.

From the regulatory agencies, multiple-management is an obstacle for credit rating agencies to open up business. Such as the competent department of corporate bond rating business is Development and Reform Commission, the competent authorities of corporate bonds, funds is CSRC, while the central bank is in charge of short-term financing bonds and medium-term notes rating business. Until 2011 the central bank was approved by state council department as the competent department of credit rating industry, marked the end of multi supervision pattern.

From the self-regulatory organization, China's interbank market dealers association of professional committee of the credit rating established in Beijing was firstly approved by the ministry of civil affairs as self-discipline organization on October 25, 2010. The Commission formally issued "credit rating business discipline guidelines of nonfinancial corporate debt" on January 8, 2013. It was a first self-discipline system in

the light of credit rating business, and also marked self regulation and management of credit rating industry towards institutionalized.

4.2 The Existing Problems in Our Supervision System

4.2.1 The Credit Rating Legislation Lag

At present, although our country has issued some laws and management measures on credit rating industry, because of the low legislative level, legislative blind spot, lack of investor protection mechanism, make the whole function run weak and pertinence. From legal regulatory framework of the EU and USA, EU based on credit rating law, the USA support on upper and lower layers, legal system construction of China obviously lag. Improving the legal and regulatory system is an important guarantee to develop the rating business and credit industry.

4.2.2 Dominance of Rating Agencies is not Stable, Above 2/3 Rating Market was Eroded by USA

Rating industry of China is still in the development stage, because of imperfect system, weak supervision, low standard of setting and vicious competition between rating agencies, the dominant position of major rating agencies is not stable. USA purchases three leading credit rating companies in China less than a year controls over 2/3 market share of credit rating, makes a serious threat to financial sovereignty and national economic security of our country.

4.2.3 Lack of Unified Rating Agency Accreditation Mechanism, Undermine the Credibility of Rating Agencies

Compared with the NRSRO system of USA, the registration system of Japan, China is lack of a uniform and stable recognition mechanism. Mainly displays, one is lack of clear and unified rules of rating agencies accreditation conditions. The national development and reform commission, the people's bank of China have not a clear standard for rating agencies certified yet. China Securities Regulatory Commission released "Interim Measures of Securities market credit rating services", though clearly defined the qualification of rating agencies engaged in securities market rating business, compared with foreign certified conditions, the rules do not embody the core factor that rating results are widely recognized by main users. No unified rating business qualification standard, is not conducive to improving the quality of ratings of credit rating agencies, also can not enhance the credibility of agencies effectively (Ran, 2011). Secondly, various identifications, as Shanghai Far East and other five companies are respectively identified by the people's bank of China and the national Development and Reform Commission.

4.3 Enlightenment from US, Japan and EU's Rating Regulatory System

4.3.1 Perfect Rating Legal System Construction, Improve Industry Standards Specification

From the origin of China's law, a sound legal system rating should include. Firstly, like "Securities Act" and

“Credit Law” related to position and function of the credit rating agencies, as well as the basic problems such as management institutions. Secondly, “administrative regulations” issued by the State Council, such as “Credit Rating Management Approach”, “Credit Rating Agency Eligibility Management Approach”, clearly establish standards of credit rating agencies, approval procedures, qualification standards and penalties for rating agencies, etc. Thirdly, the rules and regulations of supervision department, mainly including the qualification management of credit rating business personnel, specification for credit rating and quality testing standards of credit rating services. At the same time, establish relevant norms and standards of rating industry, through effective supervision of self-discipline management, to promote sustainable development of market.

4.3.2 Improve the Access Mechanism of Rating Market and Market Discourse of National Rating Agencies

The low access mechanism makes the credit rating market disorder, quantity rating agencies without strong competitiveness, leads to the erosion trouble of China’s credit market. European markets faces with the same embarrassment, the EU proposes the establishment of their rating agencies to protect national financial security. While China needs to vigorously support their local rating agencies, to improve market access mechanism and enhance the quality of the rating agencies.

Japanese review system requires the enterprise rating to provide a domestic rating agencies report, which makes the Japanese rating agencies grasp 80% of credit market. Our country should learn from review system, to improve the discourse right of national rating agencies.

4.3.3 Unified Credit Rating Accreditation Mechanisms, Standardize the Rating Market

Qualification recognition mechanism is a standard, transparent, unified recognition system. First of all, clearly define the People’s Bank of China as the unified supervision rating agencies. Since China is a developing county based on indirect financing, bank credit occupies the main position in the credit market, therefore, the central bank should be established as the core credit rating agency of the regulatory body, the People’s Bank of China with other regulators should develop appropriate regulatory measures and standards for rating agencies to implement centralized supervision. Two is to establish a unified standard of credit rating agencies. Our situation is similar with the EU, which tends to supervise by bank regulators. On the standard setting, draw lessons from “the New Basel Capital” to consider the qualification standard, like independence, objectivity, credibility, transparency, information disclosure and resource adequacy. Thirdly, improve the credit rating index system, which refers to indicators, assessment methods, evaluation criteria, evaluation weights and assessment levels generic and other projects when credit rating

agencies evaluated objects objective and fair. We should consider its scientific nature, rationality, normative and applicability, to set unified standard of rating, so that the rating agencies have a uniform scale.

4.3.4 Industry Associations Carry the Responsibility of Self-Regulation, Evolve the Monitoring System

Based on the special professional of credit rating, government and society’s supervision only stay in laws and regulations. Such as the selecting of rating method and index also require self-regulatory organization for compliance review. Self-regulatory organization should be in accordance with “international guidelines basic principles of ethics for credit rating agencies” formulated by IOSCO, to develop industry standards and guidelines, reviewed and verified when the rating results is different. Establish the certain criteria on access mechanism for rating agencies, mergers and acquisitions, business scope and exit mechanism.

CONCLUSION

In the financial crisis and European sovereign debt crisis, the performance and the role of international credit rating agencies let governments and economic organizations start to reflect deeply, the perfect rating system has become the consensus of international regulatory community. Because of the junior experience of rating regulation, learning and using the excellent experience from foreign countries is very necessary. From foreign rating regulatory experience, a perfect rating legal system, a sound regulatory mechanism and a unified accreditation system are the core of the credit rating regulation, which become the focus of regulatory reform.

In the foreign rating legislation, do not touch the problem that “issuer pays” (Zhang, 2010) business model and industry monopoly pattern in the credit rating industry. “Issuer pays” business model ties with the economic interests of the rating agencies closely, provide credit issuers motivation to overestimate the Issuer’s rating results. Industry monopoly pattern creates a convenience for the three major rating agencies to abuse discourse as social “rent-seeking”. Changes in payment methods, ending the monopoly of the industry will be the future direction of regulation of credit rating.

China as one of the world’s major creditors, financial regulators should clearly understand the potential risks and strategic significance of rating, reform “issuer pays” model as soon as possible and build rating industry regulatory legislation pattern. On the other hand, the international regulatory coordination should be involved in the credit rating industry, cultivate local rating companies to participate the competition of international rating, build a regulatory framework timely, get the equivalent status as USA and EU, to open convenient ways for local agencies to enter the international market.

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