REGULATORY PURPOSES AND IMPERFECTIONS IN RATING

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Abstract. *This paper focuses on some aspects of the problem of application for rating induced by regulators. First, are reviewed, without limitation, some of the most significant examples of regulatory abdication in favor of the rating agencies. Second, there are some problems found during the recent financial crisis affecting the market of services provided by rating agencies. Then, are briefly described the main reactions to the shortcomings of legislators and regulators and rating agencies that the crisis has highlighted.*

Keywords: Basel capital requirements of banks, financial regulation, credit risk.

INTRODUCTION

At the global level, and individual European countries, a number of rules in financial markets rely on opinions of rating agencies to regulate banks and other financial intermediaries, including on key issues such as capital requirements. In this way, and created an artificial demand for the service rating, have amplified the effects of imperfections that characterize it, we laid the premises, with the regulation of rating agencies, for the erection of barriers to entry this market and has increased the gap between the actual and the utility perceived usefulness of ratings by investors. After pointing out how the reactions of legislators, regulators and rating agencies, as appropriate, do not appear in themselves capable to solve the real issues behind these deficiencies, surgery carries some considerations about the possibility of a deeper rethink the relationship between rating and financial regulation.

THE SECOND BASEL AGREEMENT

One of the most prominent examples of regulatory expectations on ratings and represented by so-called "Basel II" on banks' capital requirements. The agreement itself limited to internationally active banks but has been extended by Directives 2006/48/EC and 2006/49/EC, including institutions operating on a national basis. The Basel 2 agreement, as well as the provisions that have incorporated the contents, the standard indicates that banks must meet to address three major risks associated with its operations: operational risk, credit risk - including risk of counterparts - and the market risk.

In this context, the ratings are used to quantify the coverage in terms of equity, demand in the face of exposure to credit risk. Basel 2 requires banks to determine the needed coverage using one of three methods for assessment of credit risk: the standard method, the method of internal ratings "Basic" (so-called Foundation IRB) and the IRB advanced (cd Advanced IRB). The use of ratings provided by entities external to the bank mainly provides for a standard method

adopted by banks are not able to take internally sophisticated assessment tools for determining the probability of default of the borrower's credit. The standard method associated with each rating class a weighting factor for the coverage needed (for example, for corporate receivables, from 20% to 150% for AAA rated below BB-).

A significant exception to the possibility of using internal rating consists of the exposures arising from securitization (for example, CDOs or ABS). For securitizations, in fact, banks using the IRB approach (basic or advanced) must make use of ratings, if any, which accompanies the issuance of securities. The financial crisis has shown, however, weaknesses in the assignment of credit ratings for securities issued by corporate vehicles in the securitization: a very significant amount of financial instruments that qualified for an AAA rating has been downgraded, even firm, since June 2007.

SOME EXAMPLES OF USE OF RATINGS FOR REGULATORY PURPOSES. In Europe, another example of reliance on ratings by the legislature is represented by the directive on c.d. eligible assets held by mutual funds harmonized, if not traded on regulated markets, money market instruments may be subject to investment only if the issuer does not belong to the countries of the Group of 10, has an investment grade rating (Directive 2009/56/EC; Art. 6 Directive 2007/16/EC).

In Europe, even after the recent financial crisis, CESR (The Committee of European Securities Regulators) renewed its confidence in the rating with the guidelines concerning the funds approved in May 2010. They stipulate that these funds may invest only in securities with high rating: it requires a judgment at least equal to the second highest level in the scale of assessment of each agency that has been expressed on that title. The assessment may be lower, at least to *investment grade*, only for government securities of euro area (CESR, 2010). The technical rule that characterizes all of these rules is largely inspired by a regulatory approach born of the United States. In that system, regulators have begun to assign ratings to effective regulation even after the crisis of '29.

The first examples of such regulation have occurred just in the banking sector by the *Comptroller of the Currency*: some rules imposed advantages to those who purchase securities *investment grade*, or even prohibited in some cases without the purchase of securities rated *investment grade*. But the most significant step towards the incorporation of ratings in prudential regulations has been made by the SEC in the mid-seventies of last century, with reference to the deduction of the assets necessary to calculate the capital requirements of *broker-dealers* (so-called *haircut*).

Consider also that, according to SEC rules, the public offer and the admission to listing of a financial instrument are greatly simplified if you have a credit rating issued on that instrument, the agency registered as a National Recognized Statistical Rating Organization (NRSRO). Another important example in the U.S. system regards, finally, the limits for investment by mutual funds: for some types of funds, in fact, different investment thresholds are set according to the rating obtained from the securities purchased (for example, SEC Rule 2a-7 on money market funds), recently, the rule has been modified to some extent, but remains intact at the time the philosophy of reliance on credit ratings. Similar rules are provided for insurance.

The significant reliance of regulators on reviews of rating agencies is questionable whether this confidence is well placed, the phenomenon of referral to the rating by legislators and regulators is of course not only the United States: it has long been introduced to some other jurisdictions (Basel, 2000). One of the areas that were more slippery from this point of view is that of structured finance.

THE RATINGS IN THE STRUCTURED FINANCE

The structured finance anticipates some particularly delicate aspects, in great part already marked also to institutional level before the 2007 (Global Committee on the Financial System , 2008), than the crisis it has contributed to evidence.

In the typical securitization scheme, the transfer of mortgages through SPV (special purpose vehicle) is financed through the issuance of bonds with different characteristics depending on the priority in repayment. The senior notes, with the right to reimbursement as a priority, are joined by junior securities, which suffered the first losses of the portfolio of mortgages and any approach for that reason, in equity securities. With reference to the senior notes shall be issued a credit rating high, sometimes at the highest level of the scale (AAA). In this context, interest in the issue of a rating as good as possible meets the preferences of all actors involved: the originator and the issuer, which in this way can raise funds at lower costs; investors, who may instead reduce the amount of capital that the prudential rules, as seen, require with regard to exposure to structured finance products.

This commonality of interests is reflected in the allocation of credit ratings higher than the creditworthiness of the SPV would be justified. The mechanisms through which we come to this result are various: the most obvious are probably the "rating shopping" and the particular nature of the relationship between agencies and broadcasters during the structuring phase of emissions, these could be added according to some - but these are facts yet to be tested - including the release of false information to credit rating agencies by the originator. As to rating shopping, the availability of evaluation manuals adopted by the rating agencies seem to have led issuers to choose among the agencies in the field of structured finance, those who were able to ensure the highest vote on equal terms (Pagano and Volpin, 2010).

As regards the relations between agencies and broadcasters in the previous step the issue of structured finance instruments, it was noted that the practice of continuously check the rating potential during the structuring of products has given rise, in essence, a form of disguised consulting with consequent impairment of the independence of agency proceedings, which seem to have given up on several occasions, a strict application of their valuation models giving better reviews than that such models would produce (Griffin and Yongjun Tang, 2009).

Finally, with regard to the level of transparency of the issuer, is the recent news of the opening of an investigation by the attorney general of New York against eight major banks for the provision of false information to credit rating agencies in the structuring of financial products with the underlying loans as they were originators.

The possibility for issuers to access the mathematical models adopted by the ratings agencies has meant that the first facility emissions and determine the underlying portfolios should be defined as (real or synthetic) starting from the

evaluation criteria selected by the second. In this context, the presence of errors and the inevitable simplifications of the models produce amplified effects not only because it is possible that a gap is consciously identified and exploited, but also because the process "backwards" (the rating of the product) increases the risk that the final decision has been influenced by this gap is what happened in particular with regard to the systematic underestimation by the rating model, the ratio of correlation between defaults on mortgages.

The agencies have traditionally argued that the danger of an increase in the rating is offset by the risk of reputational damage in the event that the ratings prove, ex post, too benevolent. A significant number of defaults caused by securities classified as high credit would, in fact, the loss of trust in the goodness of the analysis of the agencies, which would lose its most valuable asset: its reputation. However, it was noted not only that the reputational damage it can at best be a threat in the medium long term - and do not represent a credible threat for people looking for immediate profits - but also that the reference to credit ratings by regulators, quite resilient in the face of doubts about the reliability of ratings agencies, is in fact a guarantee of future earnings reasonably safe.

THE REFORMS OF U.S. NRSRO`s

The low resistance of the judgments on the credit during the recent financial crisis has led many of the legislators and regulators to toughen the rules on rating agencies or, where none exist, to introduce new ones.

Already in the seventies in the U.S. there is a register, maintained by the SEC, where the rating agencies are recognized (these are the already mentioned NRSRO). However, registration does not involve any activities subject to (unlike, as we shall see, the European system): on the contrary, membership of an agency is required to ensure that the list of NRSRO assessments issued are valid for the purposes of rules that incorporate a reference to credit ratings, for example in order to determine which financial products are fit to be the subject of investment by some people.

In order to improve the quality of ratings, was enacted in 2006, Credit Rating Agency Reform Act, which introduced a new section (15E) to the Securities Exchange Act of 1934. The implementing provisions of the new legislation have been enacted by the SEC at the end of June 2007. The main motivation behind the changes is the opacity that had characterized the process of evaluating applications for admission for enrollment in the previous system SEC (White, 2006). The standards of 2006 therefore provide more specific criteria for admission and enrollment, particularly the obligation to adopt policies for managing conflicts of interest. They are also prohibited certain conduct that might compromise the independence of the assessment agencies. For example, they cannot condition the issuance of a rating prior to the purchase of other services by the issuer or affiliated entities or condition the issuance of a financial instrument rating on the fact that it produced an opinion even on goods the underlying financial instrument.

In November 2009, the SEC, in light of the crisis, has enacted some measures to further reduce the effects of conflicts of interest in connection with the issuance of CDOs and other similar instruments. In particular, it is expected that the

issuer of such instruments to make available to rating agencies other than that evaluated the financial instruments on the issue all the necessary information so they can proceed during the life of the financial instrument to issue assessments free of conflicts of interest.

On the subject of rules of conduct and governance of rating agencies has returned the ***Dodd-Frank Wall Street Reform and Consumer Protection Act*** (hereinafter called *Dodd-Frank Act*), which among other things, required the NRSRO to have a board of directors comprising at least half of independent directors (some of whom are users of credit ratings), called to monitor the policies management of conflicts of interest mentioned above and check the correctness of the procedures for developing the assessments issued by the agency and the effectiveness of internal controls (Sec. 932).

THE THIRD BASEL AGREEMENT

The American response to the crisis has been, at least until today, a tightening of rules for the prevention of conflicts of interest. In a similar direction moved the partial review – still underway – the Basel 2 agreement.

In July 2009 the Basel Committee published a document containing amendments to the existing agreement about the relationship between ratings and securitizations, especially with regard to re-securitization (Basel, 2009).

Between the fixes provided that banks are expected to integrate external rating with their own assessments of credit risk, with the consequent necessity – worth the full deduction of exposure from own funds – to obtain adequate information on the underlying investment.

In December 2009 moreover a document is published for the consultation in which the main defects of the current agreement are found and some consequent modifications are proposed (Basel, 2009).

The consultation proposes some corrective action on the matter of credit ratings, without major changes to the setting of the previous agreement. The document points out, for example, that the system of Basel 2 may have resulted in an over-reliance on external ratings, which seems to have led in some cases, the waiver by the banks, to make independent assessments on exposures taken from them: it was therefore proposed to include in the text of Basel is a specific duty to assess their exposures, they are subject to a credit rating or not.

Leaving aside the more technical information, another significant aspect of the Basel Committee's proposals concerning the need for rating agencies, for valid judgments can be issued for the purposes of prudential regulation, comply with the IOSCO Code of Conduct (the major agencies Ratings are also largely aligned with the Code, with the exception of some deviations, although significant).

THE TRENDS IN THE EUROPEAN UNION

Along the same path of strengthening the quality rating is Regulation (EC) No 1060/2009 ("concerning credit rating agencies"). Although the CESR and ESME (the European Securities Markets Expert Group) had excluded the group need to provide for a Community regulation on rating agencies, regulation 1060/2009 has imposed rules of conduct for such parties.

The mainstay of the discipline of regulation is the obligation of registration (art. 14), which are subjected to all those who wish to carry out professional activity on the credit rating issued (art. 3 (1) (b)), where judgments issued are published (or distributed on a subscription basis – art. 2 (1)). Registration under regulation, moreover, does not replace the proceedings recognition of rating agencies already prescribed by other provisions (art. 4): in essence, the recording will be a prerequisite for the recognition of other regulatory purposes (e.g., the so-called ECAI - The External Credit Assessment Institutions for the purposes of Basel 2).

Among the rules applicable to registered persons deserve to be mentioned at least the following:

- Are made for measures to prevent conflicts of interest (Articles 6 and 7), including: (i) the requirement to have at least one third of independent directors (in charge-controlling policy development rating, the internal controls and procedures for managing conflicts of interest, the smaller agencies may be exempted on request if they demonstrate that the principals are out of proportion), (ii) the prohibition of providing advice and recommendations to entities subject to ratings; (iii) the prohibition for employees to purchase securities issued or guaranteed by entities subject to rating, (iv) the prohibition to anticipate the likely future outcome of the rating if not rated entity, (v) inclusion of the cooling-off period for employees;
- The agencies will be required to take measures of transparency about conflicts of interest (art. 6), including the publication of names of entities from which it derives more than 5% of annual turnover;
- must be disclosed in certain elements of the methods and models assessment adopted (art. 8), for example, assumptions or mathematical correlation;
- Is expected that a rating agency cannot refuse to issue an opinion on a derivative financial instrument because an underlying instrument has been assessed by another agency (art. 8);
- The rating agencies are required to be reviewed regularly (at least once year) the judgments of courts and the methodologies used (art. 8);
- Are prohibited selective disclosure of credit ratings (art. 10);
- The agencies are required to comply with criteria of fairness in the presentation of opinions (Article 10), including: identify the source of the information obtained and methodologies; report any limitations in the information underlying the rating and, if absence of reliable data or too complex financial instruments, giving the issue of the trial; provide a sensitivity analysis of credit ratings, communicate to the assessment made at least twelve hours before the release, the issuer, so that they may indicate any factual errors;
- Must be met certain requirements for regularly informing the public (art. 11 and 12), including the obligation to communicate the historical data of default for each rating category, the remuneration policies adopted by the agency; Conflicts of interests are detected and the list of top twenty clients and customers whose contribution to turnover has increased significantly over the past year, a description of ownership, a description of the system of internal control;
- Are then provided for periodic reporting obligations to the CESR (Article 11), including the right to disclose data on the frequency of transition between the classes of credit ratings.

It has been strengthened supervision by national authorities, now have the power to adopt specific supervisory measures (Article 24). The incorporation of certain provisions of Regulation 1060/2009 is the subject of Community law in 2009 finally approved in May 12, 2010. It is also a structure intended to be revised in the near future: in line with the proposals for reform of the authorities submitted in September and October 2009, 2 June 2010 the European Commission presented a proposal for amendment that assigns ESMA the responsibility for registration of rating agencies and the power to apply measures of supervision and require the application of sanctions by the European Commission (Proposal for a Regulation of the European Parliament and of The Council on amending Regulation, 2010).

The national authorities, as well as to cooperate with the ESMA in carrying out its functions - some of which, especially in supervisory information may be delegated to them - will then be empowered to monitor the use of ratings by subjects who are required refer to them (banks, insurance companies and, as proposed by the European Commission, AIF).

The same draft also suggests making arrangements for sharing, among the only rating agency, confidential information disclosed by the issuer on issue of structured financial products. The system is specifically inspired by similar provisions recently introduced by the SEC, for fear of discipline differences on these issues might lead to unnecessary regulatory arbitrage.

CONCLUSIONS

The ratings will most likely respond to an inevitable need to simplify the cognitive and, therefore, continue to have its own market. The actions of policymakers can be directed at improving this market - not necessarily in an alternative way - to eliminate the interference, which have artificially increased the demand for reviews on credit.

In deciding what measures to take, you should keep in mind that ratings are just one among cognitive simplification tools available. In the recent crisis, this system has shown some shortcomings. First, the evaluation models adopted may contain errors, as demonstrated by the large underestimation of the correlation of defaults in the mortgage industry real estate ("static defect"): it is always possible that a fact not expected to happen or not there is a correlation properly weighted, the risk of imperfections in the models is and will always be present. It is therefore advisable not to delude ourselves about the possibility that a more stringent regulation will be able to prevent the emergence of problems in the future, in this as in other areas: a sensible approach for regulators may be to not delude themselves by imagining rating infallible, thereby increasing the expectation gap from which they were afflicted ratings agencies.

Secondly, the risk rating classes are necessarily imprecise because adjustments cannot be made in real time (and, in General, the agencies try to prevent their judgments are subject to excessive volatility): will therefore always at least one rating, at that given moment does not correspond to the characteristics of the issuer but has not yet been updated and is not, therefore, a fully reliable indication ("imperfection Dynamics").

In these respects, inevitably linked to the difficult art of perspective valuations, you add the pitfalls arising from the particular configuration of rating. In the case of structured finance, the direct relationship between agencies and issuing the communication models of assessment or, in some cases, the granting of advice implied in the definition of emissions. This approach increases the risk of being exploited – not necessarily so aware – gaps of valuation models.

With reference to structured finance, the risk of unjustifiably high valuation is then enhanced by the fact that the interest of issuers, investors and agencies is in the way of assigning a rating high: otherwise, the first might not be able to sell products, the second does not charge any Commission and, finally, the third parties may have to fall back on by lower investment yields.

It is likely that the need for cognitive simplification that leads to use synthetic indicators also relates to regulators and policymakers, who have used the rating because it was the easiest way available to indicate the levels of risk of liability for regulatory purposes. However, the court not only an improper imprimatur on ratings and accentuates the value of a high credit rating and thus exacerbate the conflicts of interest. Therefore, to impose regulation based evaluations rating amplifies the inaccuracies (dynamic and static) from which they suffer. For the future, it seems appropriate to revise this approach. In the case of trusts, you may wish to consider whether to delete references to credit ratings, but does not prohibit the use of this indicator: it could be more appropriate to increase disclosure on the degree of confidence, by the operators, the ratings themselves.

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