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REGULATION AND THE CREDIT RATING AGENCIES

RESTRAINING ANCILLARY SERVICES

Daniel Cash

ROUTLEDGE

Regulation and the Credit Rating Agencies

This book examines the transgressions of the credit rating agencies before, during and after the recent financial crisis. It proposes that by restricting the agencies' ability to offer ancillary services there stands the opportunity to limit, in an achievable and practical manner, the potentially negative effect that the Big Three rating agencies – Standard & Poor's, Moody's and Fitch – may have upon the financial sector and society moreover. The book contains an extensive and in-depth discussion about how the agencies ascended to their current position, why they were able to do so and ultimately their behaviour once their position was cemented.

This work offers a new framework for the reader to follow, suggesting that investors, issuers and the state have a 'desired' version of the agencies in their thinking and operate upon that basis when, in fact, those imagined agencies do not exist, as demonstrated by the 'actual' conduct of the agencies. The book primarily aims to uncover this divergence and reveal the 'real' credit rating agencies, and then on that basis propose a real and potentially achievable reform to limit the negative effects that result from poor performance in this industry. It addresses the topics with regard to financial regulation and the financial crisis, and will be of interest to legal scholars interested in the intersection between business and the law as well as researchers, academics, policymakers, industry and professional associations and students in the fields of corporate law, banking and finance law, financial regulation, corporate governance and corporate finance.

Daniel Cash is a lecturer in law at Aston University, UK.

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Dedicated to my Mother, Jane.

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Introduction

This historic settlement makes clear the consequences of putting corporate profits over honesty in the financial markets.¹

This statement is taken from the press release in February 2015 from the US Department of Justice (DoJ), which was announcing that the DoJ, along with 20 states, had reached an agreement with Standard & Poor's (the largest credit rating agency by way of market share) which would see it pay a record \$1.375 billion as a fine for its conduct in the lead-up to the recent financial crisis. The settlement, which was to resolve allegations that 'S&P had engaged in a scheme to defraud investors in structured financial products' is by far and away the largest fine ever given to a credit rating agency. However, the statement above contains an issue that is the *raison d'être* for this book: are the consequences that this historic settlement 'makes clear' enough?

There is a tendency for those who are concerned with analysing the credit rating industry to focus upon the magnitude of the fines that have been imposed or on the choice between fines and other forms of punishment (such as imprisonment) but, although each of those issues have some validity when assessing the ratings industry, they both miss the essential point which is this: *how* and *why* were the agencies able to transgress so destructively? Endeavouring to understand the nature and the causes of their transgressions is essential if we are to properly explain what went wrong or to offer *plausible* suggestions for better regulating the agencies in the future. This book endeavours to examine the forms and causes of misconduct in the credit rating industry, but it is important to note however that the nature of the misconduct is complex and its causes are multiple. Yet and to foreshadow my argument a little, I suggest that one key component in explaining the agencies' misbehaviour includes the fact that the largest agencies established non-essential ancillary service divisions in the lead-up to the crisis. Their doing so and the levels of income such services generated, almost entirely

1 Department of Justice 'Justice Department and State Partners Secure \$1.375 billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis' [2015] Department of Justice: Office of Public Affairs (3 February).

2 Introduction

nullified and continues to do so, any ‘consequence’ that may be derived from the fines that are being predominantly used by the ‘State’ to discipline the industry.

As a result, the credit rating agencies have been left to proceed in a manner that is a genuine threat to the public interest. The notion of ‘public interest’ will be dissected throughout Chapter 2 but, for this author, the aim is to *protect* the public and make large-scale social damage a thing of the past; it is simply not an acceptable part of life that the misdemeanours of financial actors should have such a devastating impact upon the lives of citizens. The reverence attached to the ‘historic fine’ means that for the authorities *their work is now done* with regard to disciplining Standard & Poor’s. However, the profits garnered by their ancillary service division, S&P Capital IQ, means that a division that has no bearing on the accuracy of their credit ratings has protected the income from their bottom line; this is simply not a deterrent against future transgressions.

So, the protective capacity afforded to the agencies via their ancillary service divisions is the target for the reform proposal that concludes this work. This is primarily because while other proposals may be more gratifying (i.e., heavier fines or prison sentences for offenders) only small and incremental proposals are *practicable* because, ultimately, the ratings industry is extraordinarily embedded, resourceful and protected.

In order to understand why this proposal of absolute removal is optimal, we will embark upon an analysis that will describe who the agencies are and why they are deemed to be important. Having done this it will then be advanced that the agencies actually operate in a different manner than how they *ought* to, which results in the conclusion that any reform proposals or, indeed, any analysis of the ratings industry, must be focused predominantly upon what they *actually* do, rather than what we may *desire* them to do; any use of the *desired* version of events in analyses should only be used to gauge the severity of the agencies’ transgressions. We shall see examples of when the *actualities* of the rating industry have not been considered enough by legislators and regulators, which has led consistently to inefficiencies that have been exploited by the rating agencies. The most important aim is to curb this exploitation and reducing their capability to absorb the only discipline deemed appropriate is a workable way of doing so.

In order to reach this goal of establishing a reform proposal that would see the agencies’ capability to absorb financial penalties reduced, we must answer a number of important questions. For the purposes of clarity, those questions are:

Question 1 – What is the current role and status of the ratings industry and why does that role require regulation?

Question 2 – What was the regulatory landscape that surrounded the ratings industry *prior* to the financial crisis?

Question 3 – What lessons can we learn about the effectiveness of that pre-crisis regulation?

Question 4 – What regulatory reforms were introduced as a response to the financial crisis and what has been their effectiveness?

Question 5 – How does the provision of ancillary services support the agencies’ ability to transgress and what effect would the prohibition of ancillary service provision have upon that capacity?

These questions will be answered in turn and, essentially, provide the structure of the book. While the chapters will examine certain issues, there is an underlying sentiment that will reveal itself as we progress through the examination and that is one of *focus*. It is very important that we remain focused in our investigations into the financial elite, because the façade that is constantly advanced only serves to continue the ability to transgress at the cost of society. In this book, the focus is on an extremely narrow section of the financial sector and that is extremely important. It is important because large-scale examinations and reforms too easily attract scorn and derision for attempting to alter the *system*, which as an ideal is naturally bound to deter or frighten. Rather, we should aim to perform an incrementally based step-by-step approach to change, simply because it is more palatable. Aiming to promote systemic change is as noble as anything else, but it is not *practical*. It is on that basis that this examination proceeds.

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Conclusion

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