1. Introduction

Credit agencies are powerful institutions, and owing to both the growing number of issuers and products (asset-backed securities, credit derivatives) as well as to the effects of globalization, their importance has increased.[1] The total global credit derivatives market alone was estimated by the FSA in 2001 to have been over $1 trillion, expanding rapidly from a base of $180 billion in 1997.[2] It has been estimated that roughly 80% of all capital streams are influenced by ratings.[3] The expansion of the use of ratings outside the United States is a relatively recent phenomenon. In the case of Germany, for example, Moody's Investor Service opened a branch in Frankfurt as late as 1991, and was followed by Standard & Poor's in 1992. Fitch has only been represented in Germany since 1999.[4]

Basel II, i.e. the Bank for International Settlements' "International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004,"[5] aims to individualize the risk adjustments of banks by making their capital

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[1] Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities] Markets (as required by Section 702(b) of the Sarbanes-Oxley Act of 2002), Pub. K. no.: 107-204, s. 702(b), 116 Stat 745 (2002), 5.

[2] Financial Services Authority, "Cross-sector risk transfers," Discussion Paper, May 2002, 3.

[3] Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating," *Zeitschrift für Wirtschaft (ZIP)* no. 29, 2004, 1346 (1347).

[4] Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating," *Zeitschrift für Wirtschaftsrecht (ZIP)* no. 29, 2004, 1346 (1347).

[5] Bank for International Settlements' "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," June 2004, generally known as the Basel II Framework. Basel II is the follow-up agreement to Basel I. Both Basel I and Basel II were elaborated by the BCBS, the Basel Committee of Banking Supervision. The BCBS is a committee of banking supervisory authorities which consists of senior representatives of commercial bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the US. The BCBS usually convenes at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent secretary's office is located.

requirements subject to the rating of borrowers; the mechanism of individualized capital requirements is called "value at risk" (VAR) evaluation.[6] Basel II has been implemented into European law through amendments to the Banking Directive and the Capital Adequacy Directive. Germany has implement said Directive, thereby implementing "Basel II" through amendments to the KWG (Act for the implementation of the new banking directive and the new capital adequacy directive of November 17 2006 - *Gesetz zur Umsetzung der neu gefassten Bankenrichtlinie und der neu gefassten Kapitaladäquanzrichtlinie vom 17. November 2006*) and the introduction of various regulations, notably the Regulation on Banking Capital (*Solvabilitätsverordnung*).[7] VAR estimates show that credit risk accounts for roughly 54% of the risk adjustment valuation:

Figure 1: Risk proportions

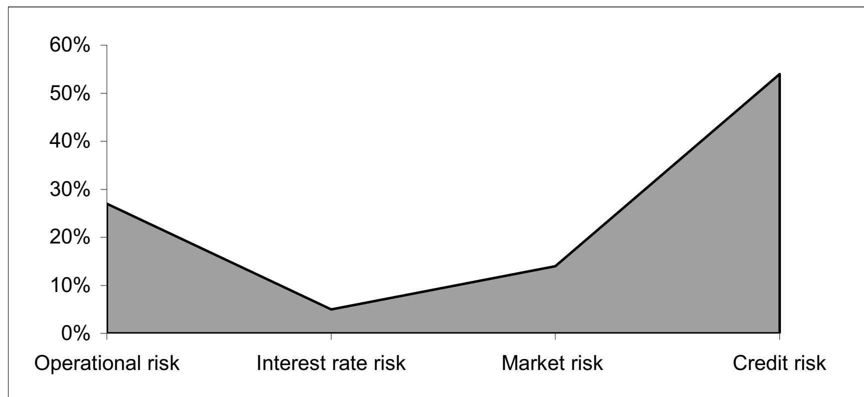
Operational risk	27%
Interest rate risk	5%
Market risk	14%
Credit risk[8]	54%

In 1975, following the bankruptcy of Bankhaus Herstatt, a German commercial bank, which left many foreign exchange obligations unfulfilled, the G-10 countries plus Luxembourg and Switzerland formed the BCBS.

[6] Its mathematical implementation is rather complex; for a mathematical analysis of Value-at-Risk (VAR) with Monte Carlo Simulation, see for example, Phillipe Jorion, "*Value At Risk. The New Benchmark for Managing Financial Risk: The Benchmark for Controlling Market Risk*", 2nd. ed., (New York: McGraw-Hill, 2000).

[7] Ministry of Finance, Gesetz zur Umsetzung der neu gefassten Bankenrichtlinie und der neu gefassten Kapitaladäquanzrichtlinie vom 17. November 2006: http://www.bundesfinanzministerium.de/lang_de/sid_380A8F5BE4FCC9B506FD719E5313A525/DE/Geld__und__Kredit/Aktuelle__Gesetze/Entwurf__eines__Gesetzes__zur__Umsetzung__Bankenrichtlinie,templateId=renderPrint.html
Draft for a Law for the Implementation of the newly adapted banking directive and the newly adapted capital-adequacy directive, (BMF-Entwurf eines Gesetzes zur Umsetzung der neu gefassten bankenrichtlinie und der neu gefassten Kapitaladäquanzrichtlinie, VII B 3 – WK 5611/05/0001), February 6, 2006.

[8] Numbers taken from: Joel Bessis, *Risk Management in Banking*, (New York: John Wiley & Sons, 1998), 36.



It therefore seems very likely that Basel II will bring about changes within the rating industry. Previously, ratings were required for the issuance of individual securities (ratings focused thus solely on the risk of the individual issuance); following Basel II, (internal or external) ratings will be elaborated to include default risk evaluations of the borrowing entity itself.[9] This will probably have an effect not just on the credit business of banks but also on the investment banking business. Generally, the duration (and the thereon dependent interest structure) of a bank's receivables (=loans) is longer, than the duration of a bank's obligations (e.g. customers' current accounts). Thus, this mismatch in duration can create a liquidity risk for a bank. The activities traced in the "banking book", an accounting category containing the proprietary trading of a bank, and the ones reported in the "trading book", an accounting category for the trading of a bank on account of customers, should be connected so that the banking book may be used as an internal swap for a mismatched risk of the interest rate and duration of loans.[10] Thus, effec-

[9] In order to calculate the credit exposure, Monte Carlo simulations invented for option pricing models are used. The terminology "Monte Carlo" relates to the idea of repeatedly running identical (computer) simulations and displaying the stochastic result as an approximation of the expected outcome; cf. Charles W. Smithson, *Managing Financial Risk, A Guide to Derivative Products, Financial Engineering and Value Maximization,* 3rd ed., (New York: McGraw-Hill, 1998), 235 and 566/567.

[10] An [external] interest rate swap is a contract for the future exchange ("swap") of interest payments. Typically, a swap has a fixed and a variable consideration ("leg"). The payer of the fixed

tively, from the bank's perspective on its liquidity reserves the risks of one category of activity have consequences on the other category of activities. No segment of a bank's business can be fairly judged on a stand-alone basis. Consequently, the importance of ratings has not just increased in quantity, but also in quality.[11] This change in quality also becomes apparent in light of the effects of sovereign ratings (as ceilings to whole economies) and the need to evaluate country risk under Basel II.[12]

The importance of the rating business has also increased as rating procedure and methodology are currently applied not only to bonds and bond issuers, but to all kinds of financial products, for example to mutual funds.[13]

Issuers and investors alike regard ratings as constituting what could be considered the most sensitive information with regard to pricing a security. Without a

leg is the payer, the other party is the receiver. Swaps are generally agreed for a term of 2 to 10 years. The bulk of swaps is traded over-the-counter (OTC) between banks, Rolf Beike, Andreas Köhler, *Risk-Management mit Finanzderivaten*, (München: Oldenbourg R. Verlag GmbH, 1997), 35.
For a more thorough explanation of internal swapping, cf. Dimitris N. Chorafas, *The Market Risk Amendment, Understanding the Marking -to-model and Value-at-Risk*, (New York: John Wiley & Sons, 1998), 36.

[11] Gudula Deipenbrock examines more precisely how the Basel II accords will be transposed into the European directive, "Aktuelle Rechtsfragen zur Regulierung des Ratingwesens," *WM* 2005, 261 (266).

[12] Stijn Claessens (University of Amsterdam), Geert Embrechts (Rabobank International), *Sovereign Ratings and Transfer Risk: External versus Internal Ratings*, 3. According to these authors country risk is the exposure to a loss in a cross-border lending, caused by events in a particular country that are – at least to some extent – under the control of the government, but definitely not under the control of a private enterprise or individual. Country risk is therefore a broader concept than sovereign risk, which is restricted to the risk of lending to the government of a sovereign nation.

[13] Michal Mann, analyst at the "Privates Institut für Fondsanalyse AG," expresses doubts about the prognosis quality of fund ratings. Michael Mann, "Mehr Vermutung denn Gewißheit, Die Prognosequalität von Fondsratings ist zweifelhaft," *Frankfurter Allgemeine Zeitung*, May 24, 2005, B15.

rating above investment grade[14] it may be impossible for the potential issuer to access the capital markets at all. Applicants use rating information to evaluate their potential employers. Issuers must therefore prepare diligently for the scrutiny of external rating agencies or bank-internal rating procedures following principles quite analogous to the one developed by rating agencies[15]. They do so by employing a new species of advisor: the rating advisor.[16]

While rating agencies still remain largely private, unregulated institutions, the Basel II rules will enable banks to adjust their capital requirements to the internally or externally rated degree of risk that is attached to a particular type of security. In this context, the Basel II rules contain provisions on the adequacy of "external credit assessment institutions" [ECAI].[17] This growing dominance of ratings might lead to a credit-crunch for small and medium-sized enterprises that have difficulties providing all the data traditionally required by rating agencies. The rating process as such might, therefore, force smaller and medium-sized enterprises to rely on venture capital rather than to seek financing from credit institutions.[18]

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[14] In the terminology of Moody's, investment grades range from "Aaa" to "Baa3," for S&P it is from "AAA" to "BBB-," Boris Hrubesch, Jürgen Witte, "Rechtsschutzmöglichkeiten beim Unternehmensrating, " *Zeitschrift für Wirtschaft (ZIP),* no. 29, 2004, 1347.

[15] Cf. the *BAFin* supervision of rating criteria, Guidelines for applications to use the IRBA for calculating minimum capital requirements, http://www.*BAFin*.de/irba-zul/zulassung_en.pdf (accessed June 1, 2006).

[16] In small to medium-sized entreprises the tax advisor is apparently quite often asked for advice, Maria Zeller, "Rating Advisory, Beraterpraxis," *DSWR*, 6/2005, 133.

[17] Ottmar Schneck shows the similarities between the Basel II and the IOSCO setting and discusses the current debate on how to implement these rules in the German legal system, "Keine Regulierung von Ratingagenturen," *DSWR*, 3/2005, 75 [76]; Anne Strunz-Happe explains the details of the ECAI regime, "Externe Ratingagenturen – Marktregulierung durch Basel II, - Vorgaben zur Anerkennung als ECAI und die aufsichtsrechtliche Behandlung externen Ratings," *WM* 3/2004, 115-120.

[18] Werner Gleißner, "Rating und Basel II, Chancen und Gefahren für den Mittelstand," *DSWR* 5/2005, 126-129.

All members of the Basel II accord are currently considering how the agreement should be implemented in national law.[19] Guidance in this respect by the Bank for International Settlements is detailed and highly technical[20] and as a result the US has already delayed its proposal for national implementation.[21] In the German case, the Ministry of Finance wants to delegate the task to the German Financial Services Authority, *BAFin*. *BAFin* is to define the requirements for complying with Basel II and, in so doing, will most likely stipulate the inclusion of ratings as a means of risk evaluation. *BAFin* is also considering adopting rules of professional conduct for rating agencies[22]. The Bundesbank has suggested a peer review model analogous to the one for chartered accountants.

A majority in the German Parliament also supports the soft-law regulation initiated by the International Organization of Securities Commissions, IOSCO.[23] IOSCO includes among its members regulators like the Securities and Exchange Commission (SEC), *BAFin* and the Financial Services Authority of the UK. The modus operandi at IOSCO is comparable to the commitology proceedings in Level

[19] "Basel II liegt im Zeitplan, Neue Vorbehalte gegen Eigenkapitalempfehlungen für Banken sorgen *BAFin*-Chef nicht, " *Börsenzeitung,* May 20, 2005, 4.

[20] Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards, A revised framework," June 2004, Bank for International Settlement, ISBN: 92-9131-669-5, pages 1-251.

21 Press release of the Federal Reserve Board, April 29, 2005 (delayed national proposed rulemaking):
"The four federal banking agencies (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) today agreed that additional analysis is needed before publishing a notice of proposed rulemaking (NPR) with respect to the U.S. implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," generally known as the Basel II Framework."

[22] "Maßnahmenkatalog der Bundesregierung zur Stärkung der Unternehmensintegrität und des Anlegerschutzes." http://bmj.bund.de/enid/ai.html (accessed Feb. 25 2003).

[23] Press release of the German parliament on common proposal by the SPD, CDU/CSU, Bündnis 90/ Greens and FDP, no. 15/2815. http://www.bundestag.de/bic/hib/2004/2004_088/88 (accessed April 1, 2004).

II of the Lamfalussy[24] process. A draft is first published before market participants are consulted[25]; IOSCO has published its Code of Conduct Fundamentals for Credit Rating Agencies. Despite its name, the "Code" is non-binding.[26] However, the EU Commission has already given soft-law mandatory effect to the "Code" through ongoing supervision by CESR. It has stated[27]:

> "First of all, credit rating agencies should incorporate all the provisions of the IOSCO Code into their own internal Codes of Conduct. Where they chose not to do so, they must explain how their Code nevertheless gives effect to the provisions of the IOSCO Code. … It is imperative that credit rating agencies not only incorporate the IOSCO Code in their own Code of Conduct but also fully comply with the IOSCO Code by enforcing their Code of Conduct in daily practice. Therefore, it is important that CESR's annual report provides for a thorough assessment of the level of day to day application of the IOSCO Code in practice, including consultation of all stakeholders."

IOSCO does not have any legislative power and depends on its members to implement its proposals into national law. However, as in the case of the "abide or disclose" rule with regard to corporate governance codices, whether the market

[24] Mr. Alexandre Lamfalussy was the chairman of a commission installed by the European Commission to render its advice on how to implement the Financial Services Action plan. Its proposal entailed a four step system: Step 1: General EU directive or regulation. Step 2: Commitology proceedings for EU implementation measures. Step 3: Transposition into national law. Step 4: Surveillance and Enforcement. For more information see "Inter-Institutional Monitoring Group, First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe (The Lamfalussy Process)," www.eu.gov.org (accessed May 2003).

[25] In this case so-called "Public Comments on Code of Conduct Fundamentals for Credit Rating Agencies"; the who-is-who of public interest groups and market players responded to the questionnaire.

Most market players basically agreed with the careful approach of the IOSCO rules; see for example, Vickie A Tillman, Standard & Poor's, "Public Comment on Code of Conduct Fundamentals for Credit Rating Agencies," November 8, 2004, 2; Raymond W. McDaniel, "Moody's Investors Service, Public Comment on Code of Conduct, Fundamentals for Credit Rating Agencies," November 15, 2004, 2.

[26] On this deficiency and the lack of efficient sanctions, cf. Matthias Habersack, "Rechtsfragen des Emittenten-Ratings," *ZHR* 169 (2005), 185-211 [192].

[27] European Commission, Annual Report on Credit Rating Agencies, May 17, 2006, MARKT/FF/D(2006) 6428.

will enforce abidance to the "Code" remains to be seen. The business community has already indicated that it would "follow up to see how the various agencies seek to implement the Code's provisions."[28]

In any case, in the EU the marge of discretion of rating agencies is decreasing. This evolution is by no means exception. Other players in the financial markets have become subject to increased scrutiny be means of the Markets in Financial Instruments Directive (MiFID). The MiFID imposes on *investment firms*[29] to disclose any remuneration received from persons other than their clients when rendering individual advice.[30]

In the US, SEC is scrutinizing rating agencies as a result of the Sarbanes-Oxley Act. According to Section 702 of the Sarbanes-Oxley Act, SEC will conduct a study of the role and function of credit rating agencies in the operation of the securities market.[31]

Outside the US, Germany and Japan in particular have begun to complain about the dominance of the three leading (US based) rating agencies: Moody's, Standard & Poor's (S&P), and Fitch. Moody's and S&P have a combined market share in excess of 80%, while Fitch's market share is approximately 14%.[32]

[28] Sir Adam Ridley, "London Investment Banking Association," Annual Report 2004, 9; www.liba.org.uk.
[29] MiFID applies only to investment firms and regulated markets (Art. 1) . Art. 4 para. (1) MiFID defines: "'investment firm' means any legal person whose regular occupation is the provision of one or more investment services to third parties and/or the performance of one or more activities on a professional basis" Investment services are defined in Annex I to MiFID to include (among others) investment advice.
[30] Art. 4 para. (4) MiFID: "'Investment advice' means the provision of personal recommendation to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments;"
[31] Cf. page 68 et seq. for a more in-depth explanation of the impact of Sarbanes-Oxley on rating agencies.
[32] Jenny Wiggins, "A Chance to Step Into the Light," *Financial Times,* December 9, 2001, at IT 10.

Moody's alone rates bonds worth more than $30 billion in more than 100 sovereign states.[33]

Masaj Shiokawa, the Minister of Finance of Japan, criticized the downgrading of the credit risk of his government's outstanding bonds and announced legal steps in response. [34]The above-mentioned criticism should not be taken lightly. In the past, rating agencies have probably favored UK and US issuers.[35] The regulatory grip on rating agencies is, therefore, slowly increasing. This paper contends that rating agencies should not be subject to extensive regulatory supervision as this might threaten their objectivity. The various regulatory proposals, however, will not deal with the issue of the liability of rating agencies for wrongful ratings.

Some authors have argued that rating agencies will do everything in their power to avoid inadequate ratings, despite the apparent asymmetric information in

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[33] Guido Leidig, *Leistungsprofile von Rating-Agenturen, Bundesverband Druck und Medien e. V., Abteilung Betriebswirtschaft*, (Wiesbaden 2003), 30.

[34] Cf. the complaint letter of Japanese Ministry of Finance at http://www.mof.go.jp/jouhou/kokusai/p140430ecov.htm; Ottmar Schneck, professor at the European Business School, http://content.bfinance.de/bfinance/de/Bfcontent.nsh(allnewsarticles2/; still more provocative is the criticism of Thailand's Deputy Prime Minister in the Thai newspaper *The Nation* following Moody's announcement of a review of Thailand's credit rating in February 1997: "The name of the firm itself is inauspicious. I have heard that the company's financial status is no good and it has to rely on extortion. When a country doesn't give it what it wants, the company tries to destroy the country. […] in the past, there was no such crazy rating firm and we lived. Since they are trying to destroy us, why can't we try to destroy them?" Cited by Roman Kräussl, "Sovereign Risk, Credit Ratings and the recent financial crises in Emerging Markets, Empirical Analysis and Policy Implications," *Schriftenreihe des Center for Financial Studies an der Johann Wolfgange Goethe-Universität Frankfurt am Main, Monographien XVIII,* (Frankfurt am Main 2003), 5.

[35] The Japanese Ministry of Finance contends that sovereign bonds should not be assessed solely by fiscal indicators, but comprehensively and in the broader context of the economy at large. It complains that Japan's saving surplus (the largest in the world), the refinancing of debt in the domestic market, the current account surplus and the foreign exchange reserves (largest in the world) are not taken into account. On the other hand, it alleges that the ratings for UK and US bonds have occasionally been too optimistic. According to the complaint, UK foreign currency bonds were rated AAA in 1978 only two years after the sterling crisis and [IMF] Fund borrowing in 1976. US Treasury bonds, on the other hand, maintained AAA status in the mid-80's when the sustainability of the US twin deficits was suspect.

bond issuances and the apparent conflict of interest. Although the risk of abuse cannot be completely ruled out, it will be demonstrated that for economic reasons, it is unlikely that Moody's or S&P will abuse their powers (section 2.6. The economic unlikelihood of the risk of abuse). This claim is based on the assumption that the dominant rating agencies will go to great lengths to protect their reputation.

However, it may be reasonably argued that the probability of abuse is negatively correlated to competitive pressure. At least in certain capital markets where the "two-rating-agencies rule" is not well established, a certain risk of abuse will, therefore, persist. Even in well-developed capital markets, cases have been reported in which rating agencies have failed miserably in their task. The SEC reacts to these failures through the establishment of a number of regulations.

If such risk of abuse cannot be avoided by the economic incentives of the rating business, the legal rules of the rating business will have to decide on the liability of rating agencies for wrongful ratings. Last but not least a concrete proposal for both a regime of administrative regulation (9.2. Limited administrative control) and for a regime of liability (9.1. Limited judicial control) will be made.