

# Credit Rating Agencies in India: Have We Done Enough?

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Credit rating agencies (CRAs) exist to primarily evaluate the creditworthiness of corporate borrowers who directly seek funds from the public without going to a bank. This study seeks to review the developments of CRAs in India, taking into consideration the recent global financial crisis. Emphasis is placed on the existing and desired regulatory structure in India vis-à-vis the legislation in the United States (US) and the European Union (EU). In perspective, affixing liability to the CRA is seen as a prudent and a decisive step in checking the potential malfunctioning in the system. Likewise, it would be a welcome move if the Securities and Exchange Board of India (SEBI) leads the way in affixing liability to credit rating agencies for reckless rating.

*Keywords:* capital markets, credit ratings, regulatory structure

## INTRODUCTION

*“There are two superpowers in the world today in my opinion. There’s the United States and there’s Moody’s bond rating service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful.”*

– Thomas Friedman

Credit rating agencies were primarily established to assess the creditworthiness of corporate borrowers who directly borrowed credit from public, without going to a bank (India Ministry of Finance, Capital Markets Division, 2009). The first rating agency to be established was by John Moody in 1909 and it published a manual called *Moody’s Analyses of Railroad Investments* (Devine, 2011). It was the first rating publication in the history. By mid 1920s, others became cognizant with the idea of having rating agencies. This marks the establishment of other players in the rating business, that is, Standard Statistics, Poor’s Publishing, and Fitch. Later,

Standard Statistics and Poor's Publishing merged to form Standard & Poor's (Lowenstein, 2008). The agencies have since grown manifold in size and influence.

Credit rating is "an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories" and credit rating agency is "a legal person whose occupation includes the issuing of credit ratings on a professional basis" (The European Parliament and of the Council of the European Union, 2009, Article 1(b)). Under Indian Law, credit rating agency is defined as "a body corporate which is engaged in, or proposes to be engaged in, the business of rating of securities offered by way of public or rights issue" (Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, Regulation 2(1) h). According to an estimate, there are more than 130 rating agencies working in different jurisdictions of the world (The Technical Committee of the International Organisation of Securities Commission, 2003). There are however three major credit rating agencies in the world, that is, Moody's, Standard & Poor's, and Fitch. In India, Investment Information and Credit Rating Agency of India Limited (ICRA), Credit Rating and Information Services of India Ltd. (CRISIL), and Fitch Ratings India Private Ltd represent Moody's, Standard and Poor's, and Fitch respectively (India SaEBo, 2012).

The credit rating agencies need to be licensed by the Market Regulators in order for them to operate. In India, they need to obtain a certificate of registration from the Securities and Exchange Board of India. Credit rating agencies play an important, if not absolute, role in investment decisions of the investors. They help in improving market efficiency by rectifying information asymmetry between borrower and lender, thereby lowering cost (India Ministry of Finance,

Capital Markets Division, 2009; Bai, 2010). The alphanumeric symbols used by the agencies for rating are largely the same, with a few differences. The symbols range from AAA (High Investment Grade) to D (Payment Default). With the rising role of credit in modern transactions, the role of credit rating agencies has become critical. There are often private contracts which have rating triggers which allow the investors to take action in case the ranking falls below a specified level (Bai, 2010).

The quote by Thomas Friedman, in the beginning of the paper, reflects the true power of these rating agencies; they have the potential to cause immense distress to an economy. This has found credence in the current Eurozone crisis, where they created further problems to the already ailing economies. The significant rise in the borrowing cost on Italian five-year notes (at an average yield of 6.29%) is surely a result of the downgrade, which led to lost investor confidence. The Wall Street Journal reported that "Italy was forced to offer investors a euro-era record interest rate to place five-year government bonds" (Phillips & Emsden, 2011, par. 1). The enormity of the problem can be appreciated from "doubts over the new government's ability to rein in Rome's large debt load" (Phillips, 2011, par. 1). Also, the downgrade of Hungary to junk by Moody's and S&P had led to speculation that there would be significant rise in the borrowing cost of the Government (McCarthy & Feher, 2011). The rating downgrades have been devastating for the already troubled economies, which have been struggling to recover. A higher rating would certainly have helped them in a smooth recovery. Often, the reason of distress is the mandate for certain investors to invest in investment grade assets. This holds true for the huge institutional investors such as pension funds and so forth, which have provisions in their charter limiting their investment to investment grade assets (McCarthy & Feher, 2011). Therefore, once an instrument falls below an indicated grade, the investor needs to withdraw, resulting in further pressure to the borrower.

The credit rating agencies are believed to improve market efficiency by reducing information asymmetry between the borrower and the lender by indicating the probability of default or delay in the payment of the obligation. The efficient market hypothesis and the capacity of the rating agency in evaluating the correct position of a financial instrument are at loggerheads. The efficient market hypothesis suggests that the price in market reflects the actual value of the instrument, based on the background of the market already having all the relevant information. It leads to a debate over the capacity of the rating agencies to add further value over the already existing market information. It would really be very difficult to conclusively determine the role of each in real market terms, owing to factors like cognitive bias. Yet, it remains an interesting argument against the very existence of credit rating agencies.

“One of the important functions of law review articles is to lock the barn door after the horse has been stolen i.e. to analyze the causes of a breakdown in the intended function of protective law after its occurrence, and to propose changes in the law to prevent it from recurring. This is particularly important in the financial markets, where one of the few things that is certain is that there will be more horsing around” (Mendales, 2009, p. 1361). With catastrophic blunders such as the failure to warn about the bankruptcy of Enron and WorldCom, Freddie Mac and Fannie Mae being rated AAA when they were rescued (Marrs & Ferguson, 2010), AIG and Lehman Brothers rated AA minutes before their collapse (Nasiripour, 2009), the inconsistency in rating, structured finance, and so forth, all pointing at the potential problems in the credit rating business, beside others, it has become imminent to revisit their regulatory structure. It would not be appropriate to say that the laches in the regulatory structure can lead to devastating consequences; truth is, we have already suffered a lot.

The post crisis development has been significant. The United States Securities Exchange Commission and the European Securities

Market Association have responded with stark amendments to the law relating to the regulation of credit rating agencies. The regulatory response of US and EU has been interesting, and for the other countries, particularly India, not being the prime beneficiary of the 2008 crisis, it is a warning signal to patch the laws, so as to avoid any adversity.

The more important question that I seek to answer is why now. As regards the status of the crisis of 2008, looking at the current state of financial affairs, it would be inappropriate to say that we are in a post crisis world. But on account of passing of significant time after the dawn of the crisis and the developments by other countries, it becomes important to review our laws.

In this study, I seek to review the developments of India, with a background of the recent financial crisis. Largely, the emphasis remains on the existing and desired regulatory structure in India. A brief preview of the US and the EU legislation is also given.

## **ROLE OF CREDIT RATING AGENCIES IN THE CREDIT CRISES**

It is desirable to have a background of the fundamental aspect of the crisis to appreciate what went wrong with the rating agencies. The burst of the Internet bubble and attack on the World Trade Centre created tremendous stress in the U.S economy. In order to fight the stress, the government lowered the Federal Reserve interest rates to less than 1% (Federal Reserve Bank of New York, 2008). This prompted people to borrow and spend. Lenders were both from the public and private sectors. Fannie Mae and Freddie Mac, both established and guaranteed by the government, gave out mortgages (Alford, 2008). On the other hand, the private sector, using securitisation, financed the mortgages. Large portfolios of the consumer loans financed by the private sector were sold by banks and other lending institutions to the investment banks. These investment banks transferred these loan portfolios to specially

formulated Special Purpose Vehicle (SPV) and then securitised them into Collateralised Debt Obligations (CDO), and sold in the market to the investors. Therefore, the default on underlying loans would have had direct impact on the obligated payments of the CDOs.

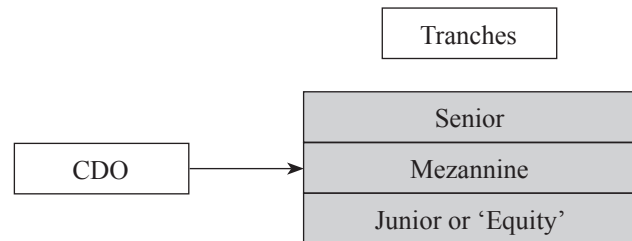
The consequence of this large-scale lending was twofold. The government sponsored enterprises suffered an estimated debt of USD 5.2 trillion which had to be eventually paid out using tax payers' money (Kopecki, 2008), and the private sector, using mortgage backed security, helped the near collapse of financial markets. The damage is still being seen in the struggling United States economy.

The root of the crisis lay in the financial innovations called CDOs. The crisis was not the only result of CDOs, but even other more complex instruments (i.e. Synthetic CDO, CDS, etc.), which played an equally important role. For the purpose of this paper, I shall only look at CDOs, as they are primarily concerned with the credit rating agencies.

The CDOs are one of the best pieces of financial engineering. There is no standardisation, but they are custom made to the requirements of the issuer (Crawford, 2010). It has multiple tranches for the subscribers to choose from. The tranches are not limited to the demonstrated three in Figure 1. The tranches can be multiple depending upon the requirements of the issuer (Crawford, 2010). These tranches are of crucial importance in a CDO. It reflects the different level of risk and reward to the subscriber. The structure of the CDO in Figure 1 is shown as having three tranches, that is, senior, mezzanine, and junior or equity. Once the money is received from the underlying asset of the CDO, first, the holders of senior tranche are paid in full, then comes the chance of the mezzanine tranche holder to be paid in full and finally then, the junior or equity tranche holders are paid. This waterfall arrangement of credit enhances the position of the higher tranche holders.

As rating is based on the payment risk, the senior tranche is rated the highest, for it comes first in turn to receive payments, then others follow.

The mezzanine tranche is the second to receive the payment, after senior tranche is paid in full. This is why they are rated lower than the senior tranche. The junior or equity tranche is the last to receive the payment, after all the other tranches are paid in full, so it is rated the lowest. This represents more risk than other tranches, hence they are rated the lowest.



**Figure 1:** Structure of CDO

The risk taken by the owners of the lower tranches is rewarded with higher interest rates than the “comparatively safer” and less risky tranches. It also provides incentive subscription to the lower ranked tranches. Therefore, the junior or equity tranche receives the highest interest, as they are most risky. The interest offered in the mezzanine tranche is lower than the junior or equity tranche, but higher than the senior tranche. The tranche to receive the lowest interest is the senior, as they are the least risky ones.

The decreasing credit risk to the banks owing to securitisation (creating CDOs out of asset portfolios and selling on markets) of their loans encouraged them to lend more and more, leading to deterioration in the lending quality, thereby inducing moral hazard in the market. The securitisation was not the main problem. The real issue was bundling of sub-prime lending into the CDO's. Professor Claire A. Hill remarks “... financial engineers are always thinking creatively, devising ways to securitize new assets. Mortgage-backed securities (backed by prime mortgages) were old hat - why not try securitizing sub-prime mortgages?” (Hill, 2009, p. 591). The sub-prime loans were preferred by the investment banks over the prime loans due to the higher interest obligation of the underlying borrowers leading to

more risky loan portfolios being securitised and sold in the market (Marrs & Ferguson, 2010). For the investors, it meant larger interest, which made it more lucrative in the market, leading to higher demand. It was rightly claimed as a “bankrupt business model” by the famous character “*Gordon Gekko*” in the movie “*Wall Street: Money Never Sleeps*” (Stone, Pressman, & Kopeloff, 2010). The model could have sustained, had the home prices in United States continued to rise. The then Federal Reserve Bank Chairman, Ben Bernanke, ruled out any possibility of the fall in housing prices. The impending crisis was publicly predicted by many analysts, but their prediction was dismissed (Devell & Borgs, 2010). In fact, there were many hedge funds betting against these mortgages (by buying Credit Default Swaps) but could not sustain the cost until the time markets fell. Those who were successful in waiting made a fortune. The investment bank Goldman Sachs was selling these CDO’s and was secretly making multibillion dollar bet against its collapse (Marrs & Ferguson, 2010).

The deteriorating lending standard combined with fall in underwriting standard was all it took. This led to substantial defaults on the underlying debts in the later stages. What is more distressing is the later discovery that often no collateral was taken by the lending institutions while lending. The amount of money made by the underwriters was huge, and there was drastic fall in the underwriting standards to create more and more of these.

Then came the credit rating agencies, they put “gold seals” on these CDOs making it appear safe for investment (Lowenstein, 2008). This drove the demand for such instruments. The process of rating the securities by the rating agencies was unusual. There was no proper model to rate the financial innovations (CDOs). The structure of CDO is such that its value depends on the underlying assets and the collaterals. There is definitive evidence to show that the investment banks pursued the rating agencies to rate the CDOs without taking into account the status of the underlying collaterals (Hill, 2009). This creates a

doubt that there may be cases where they might have successfully influenced the rating process. In another case of recorded irregularity, it came out that once Moody’s discovered a flaw in their model that rated the CPDO (Constant Proportion Debt Obligation) as AAA, in place of fixing the model to correct the error, it was corrected so that the future instrument could continue to be AAA (Jones, 2008).

There was also an innovation to create CDOs out of existing ones. Considering the CDO as a building, the lower floors of the already existing CDO’s were combined to give birth to new CDO’s, which were sent to be rated again. Intriguingly, the higher tranches of the new structure were again rated AAA, defying reason when the new CDOs having the same lower tranches, which have been held as “high risk” rating in other CDOs, were rated AAA (“High investment grade”) under the new structure. In case of a flood, all the lowest floors would be flooded at once. This would fail the reason behind rating the senior tranches of the new structure as AAA. This served no purpose to the investors but certainly to the investment banks who found it tough to sell the “low rated” tranches of the original CDO’s (Lewis, 2010).

The credit rating agencies are considered to be the gatekeepers. They could have given negative rating to the CDOs. It would have resulted in funding cut off to such products and then no one would have engineered it further. An analyst bravely puts that the credit rating agencies very well knew what they were doing. They knew that, had they not rated the instruments highly, people would not have bought it, leading to the loss of opportunity for them (rating agencies) to make money. Everyone was making huge money, the mortgage lenders, the investment banks and the credit rating agencies. McDonald and Robinson wrote, “How on earth could a bond issue be AAA one day and junk the next unless something spectacularly stupid has taken place? But maybe it was something spectacularly dishonest, like taking that colossal amount of fees in return for doing what Lehman and the rest wanted” (2009 as cited in Hall, 2009, par. 18).

The rating of Mortgage Backed Securities cost twice as much as Corporate Bonds (India Ministry of Finance, Capital Markets Division, 2009). The profit of all the rating agencies saw dramatic rise in this period. Moody's in particular, went public and its stocks and earnings increased six folds and 900% consecutively (Lowenstein, 2008). "In 2001, Moody's had revenues of \$800.7 million; in 2005, they were up to \$1.73 billion; and in 2006, \$2.037 billion. The exploding profits were fees from packaging ... and for granting the top-class AAA ratings, which were supposed to mean they were as safe as U.S. government securities," said Lawrence McDonald & Patrick Robinson (2009, p. 217) in their recent book, "A Colossal Failure of Common Sense."

The opinions of leading commentators say that the CRAs played an active role in the crisis by indulging in fraudulent practices. Their role was contested in the court, but they successfully sought refuge under first amendment of the American constitution to claim their rating function as freedom of speech.

There are dissimilar opinions over the role of credit rating agencies in the financial crisis. Many authors are of the opinion that the CRAs were at fault (Hill, 2009). Remarkably, there are some who hold a different opinion. The main argument against the misuse of the credit rating function of the agencies is that, they claim, the agencies could never be so foolish to ruin their reputation. Once they ruin their reputation, no one would buy their ratings, leading to a more serious long term losses. Yet, "The short-term payoffs were high-the agencies [Credit Rating Agencies] were indeed making huge quantities of money. But they weren't making enough money to look as foolish as they do now..." (Hill, 2009, p. 596).

## **REGULATORY REGIME IN THE UNITED STATES AND EUROPEAN UNION**

There is a general concern among the regulators across the globe to reign in the credit rating agencies. The 2008 credit crisis has given

regulators enough reason to push the amendments. There have been some radical proposal and changes from the earlier approach towards regulation of the CRAs by the regulators.

In the US, there were some reforms undertaken after the corporate scandal of 2002, which came in the form Credit Rating Agency Reform Act, 2006, but eventually failed in preventing the rating agencies from acting grossly during the 2008 crisis. In order for the credit rating agencies to function in the US, they are required to gain recognition from the SEC. Upon getting recognition, they are registered as nationally recognized statistical rating organization (NRSRO). After the passing of the Credit Rating Agency Reform Act, 2006, the authority of the SEC to confer 'Nationally recognized statistical rating organization' status was revoked and the regime was partially liberalised to allow agencies with three years of experience to experience to register as "statistical ratings organizations." There are currently 10 rating agencies registered as NRSRO.

The Credit Rating Agency Reform Act of 2006 has introduced many positives, which includes preventing the SEC from regulating the substance of credit rating. The act remains the principal legislation in regulating rating agencies operating in the US. Although the Act aims to induce accountability and improve the rating standards, it fails on some counts. The principal failure is the lack of accountability of the agencies, as they are given protection of the first amendment of the American constitution, that is, their rating being termed as mere opinion and afforded protection under freedom of expression.

Despite the protection of freedom of speech, there is a tactical shift in the approach of the courts in looking at the work of the credit rating agencies. Such can be seen in recent judgments.

The US traditionally considers the ratings given by the credit rating agencies to be an opinion to the public. Therefore, the CRAs are given the benefit of freedom of press under the First Amendment of the American constitution. The dimensions are rapidly changing. In the *Abu Dhabi Commercial Bank vs. Morgan Stanley*

(2009), the court held that ratings on notes sold privately to a “select” group of investors was not a public concern, hence the CRAs cannot avail the benefit of the protection under the first schedule of the American constitution. This is a bold step in affixing liability on the rating agencies and a radical shift from the previous position. In my opinion, it is ironic that the CRAs need accreditation (NRSRO status) for performing the rating function, and then are allowed protection under freedom of speech.

There were efforts made by congress to reign in the rating agencies through the Dodd-Frank Act. The Dodd-Frank Act took away the protection of First amendment, that is, CRAs ratings being treated as an opinion as a part of freedom of expression, which was available to the rating agencies. But, the Act could not sustain the prolonged lobbying and threat, and its implementation was put off indefinitely by the SEC.

In the EU, Regulation No. 513/2011 of the EU aims at regulating the credit rating agencies in the EU. It establishes an effective supervisory framework for the regulation of the agencies in the EU. The harmonisation of the regulation at the EU level, and the positioning of the European Securities and Markets Authority (ESMA) as the single supervisory authority aims at better regulation and to remove any inconsistency.

The Credit Rating Agencies (Amendment) Regulations 2011 (SI 2011/1435) came into force in the UK from 1 July 2011. Such is aimed at revoking authority from the national regulator, that is, Financial Services Authority (FSA) and transferring the power of supervision to the ESMA. The ESMA has been given new information gathering powers and powers concerning enforcement of sanctions and penalties.

The efforts for imposing civil liability on the rating agencies have been reinitiated. Such has come in the form of the CRA3 proposal, which has been prepared by the ESMA. Verena Ross (2012) of ESMA, in her speech “Credit Rating Agencies: What are the Next Steps?”,

has welcomed the CRA3 proposal for increasing disclosure, addressing conflict of interest, and introducing civil liability. If implemented, EU will be the first jurisdiction to impose civil liability on the rating agencies, and this can be viewed as a much positive progress.

Initially, there was a proposal to create a European credit agency to counter the dominant rating agencies. (Prentice & Reisberg, 2012) Also, there have been rapid efforts to affix liability on the rating agencies. Comparing the imputation of liability by the EU to the US reveals much contrasting differences. The EU has undertaken legislative efforts to impose liability, while in the US, the role is discharged by the proactive judiciary. Though, lack of legislative effort can be factored to the excessive lobbying by the rating agencies in US, such can be predicted with the help of the precedent of the indefinite postponement of the implementation Dodd-Frank Act.

## **REGULATORY REGIME IN INDIA**

In India, there are various products that require mandatory rating. These range from rating capital market products to rating for capital adequacy requirement under Basel II regulation. Therefore, regulatory burden is shared between different governmental wings. The supervision by the Securities and Exchange Board of India (SEBI) is limited to securities issued by public or rights issue. These include Public/Rights/Listed issue of bonds, IPO Grading, Capital protection oriented funds, and Collective Investment Schemes of plantation companies. The Reserve Bank of India (RBI) frames regulation for rating Commercial Paper, Bank loans, Security Receipts, Securitised instruments (Pass Through Certificates), and Fixed Deposits by Non-Banking Financial Companies & Housing Finance Companies. Performance Rating of Parallel Marketers of Liquefied petroleum gas/Superior Kerosene Oil (LPG/SKO) is regulated by Ministry of Petroleum and Maritime Grading by Directorate General of Shipping.

The adoption of Basel II standards by the RBI has induced new risk in the banking system. The vital reason behind having capital adequacy requirement is better positioning of banks in case of loss of capital. In other words, it helps banks withstand shock better; although, Basel II in itself is an improvement in the existing banking standards. Basel II relies on “prudential provisioning of capital on the basis of risk weights attached to assets” (India Ministry of Finance, Capital Markets Division, 2009, p. 22). It targets a delicate balance between the ratings and the banking regulations. The RBI confers External Credit Assessment Institution status to the rating agencies for rating the bank loans under Basel II. It is, however, not mandatory for the banks to have their loans rated, but in case of holding less risky loan portfolio, helps decrease the minimum capital adequacy requirement resulting in more liquidity to the banks. Consider a situation of a risky portfolio being rated generously, the minimum capital adequacy requirement would fall, thereby increased threat to the solvency of banks in case of large capital losses. Therefore, it has necessitated further concern in regulating the rating agencies properly.

The regulatory framework for Credit Rating Agencies comprises of administrative regulations framed by SEBI. It is one of the early regulators in

the world, in regulating Credit Rating Agencies, the Securities Exchange Commission started in 2007, and the EU did it later (India Ministry of Finance, Capital Markets Division, 2009). In exercise of the powers conferred by Section 30 read with Section 11 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the SEBI has framed Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. It uses both amendment notifications and circulars for periodic reforms. It would be a part of the exercise to see the laws presently in force.

***Grant access to responsible firms into the business by setting high eligibility criteria. []***

Chapter 2 of the regulation deals with the process of registration for the purpose of running a rating agency. It contains detailed procedure for making the application, eligibility criteria, power of board for seeking further information, grant of certificate and its conditions, renewal, procedures for non-grant, and effect of refusal to grant.

Any person proposing to commence the work of credit rating agency shall make an application to the board for grant of the ‘certificate of registration’. The persons carrying on the business of the Credit Rating Agency at the time of commencement of the regulations

**Table 1**

***Registration Requirements***

<p><u>Registration requirements</u> (Regulations 3-7)</p>	<ul style="list-style-type: none"> <li>• Application must be made to the board.</li> <li>• Applicant must be promoted by a person named in regulation 4.</li> <li>• Applicant is set up and registered as a company under the Companies Act, 1956.</li> <li>• Memorandum specifies rating as main activity.</li> <li>• Minimum net worth of 5 crores (USD 1,000,000)</li> <li>• Other requirements mentioned in regulations 5(d)-(k).</li> <li>• Furnish information as required by the board.</li> </ul>
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Source: Regulation 3 – 12, Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999



shall make an application within the prescribed period of three months. The board may however, extend the period to six months with reasons to be recorded in writing. The application shall be accompanied with non-refundable fee of fifty thousand rupees. The entry remains prohibited to any person other than promoted by any public financial institution, scheduled commercial bank, foreign bank operating in India, foreign credit rating agency, and any body-corporate having a minimum net worth of rupees one crore (USD 200,000). For the consideration of application by the board, the applicant has to be registered under companies act, 1956, have a minimum net worth of rupees five crore (USD 200,000) and have rating as one of its main object in the memorandum of association. In case of existing credit rating agencies at the commencement of the regulation, they shall be deemed to satisfy the minimum net worth of five crore (USD 200,000) if complied with a period of three years from the commencement of the regulation. The regulation strictly bars any applicant who is either directly or indirectly concerned with a person whose application has earlier been rejected or as been subject to any proceeding for the contravention of the act or any rules or regulations made hereunder. The Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004, shall apply to the applicants for credit rating agency.

The applications inconsistent with the requirements under the regulation are liable to be rejected. The board shall give the applicant the opportunity to rectify the objection within a period of 30 days, with a provision to extend to 30 more days at the discretion of the board. The board may require the applicant to furnish further information and in person appearance of the representative for the purpose of consideration of application. On being satisfied with the applicant, the board shall grant a certificate in Form 'B' upon payment of a sum of rupees five lakhs. The condition on the certificate include undertaking to comply with the periodic regulations made by the board and responsibility to inform the board

of any misleading disclosed statement or any change undergone from the time of furnishing in the application. The certificate shall be valid for a term of three years, thereupon requiring renewal. An application for renewal shall comply with similar requirements of fresh certificate but not be made less than three months before the expiry of the period of registration.

In case of a decision to not grant a certificate to an application for either issue of a fresh certificate or renewal, the board shall grant a reasonable opportunity of hearing to the applicant, thereupon, communicate its rejection stating the grounds within a period of 30 days. The applicant can, within 30 days of receiving the communication, apply to the board for reconsideration of the same. The board shall reconsider the application and communicate its decision to the applicant in writing, as soon as possible. The effect of refusal to grant registration shall result in non-undertaking of rating activity by a new applicant. In case of existing rating agencies, they shall cease to carry on the rating activity; but in the interest of the investors, may be permitted to complete the rating assignments already undertaken. The board may further make provision for transfer of record, documents or reports to protect the interest of investors and determine the terms and conditions for such appointment.

The entry requirement remains rigid in granting entry to the firms in the rating business. Not surprisingly, there are only six rating agencies working in India at present. The demanding qualifications help ward off less responsible firms with inadequate infrastructure to enter the business of credit rating.

### ***Lay down general obligations for the Credit Rating Agencies***

The credit rating agencies are required to abide by the elaborate rules of code of conduct laid out in the third schedule of the regulation. In brief, it aims at investor protection, integrity and ethical discharge of duties by credit rating agencies.

**Table 2*****Obligations of Credit Rating Agencies***

Obligations of the CRAs	<ul style="list-style-type: none"> <li>• Required to adhere to the code of conduct in the third schedule of the regulation.</li> <li>• A written agreement shall be entered into with the client.</li> <li>• The CRA shall monitor the instrument through the lifetime of the security and the dissemination of the information shall be efficient.</li> <li>• Internal procedure shall be formed for prevention from contravention of any law.</li> <li>• The rating definitions and rationale shall be disclosed.</li> <li>• Upon any request for information by the board, such shall be complied with.</li> <li>• The circulars issued by the board shall be complied with.</li> <li>• The obligations concerning rating process in regulation 24.</li> <li>• A compliance officer shall be appointed for compliance with the laws.</li> <li>• The books and accounts shall be maintained and kept for a period of 5 years.</li> <li>• The CRA shall maintain all the information disclosed by its client as confidential, except when required under any law.</li> <li>• The CRA should not rate the securities issued by its promoter or any entity connected with its promoter.</li> </ul>
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*Source: Regulations 13-24, Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999*

The regulation requires rating agencies to enter into a written agreement with each client for rating their products. The agreement shall have provisions concerning the rights and liabilities of the parties, the fee to be charged, periodic review of rating, co-operation by the client in the rating process, and disclosure of rating to client through regular method of dissemination, irrespective of acceptability of the same by the client. The client shall agree to make disclosures in the offer document of rating assigned to the instrument in the last three years along with the rating given by any other rating agency, which was not accepted by the client. In case of any debt issue equal to or exceeding rupees hundred

crore (USD 200,000) the client shall obtain rating from at least two rating agencies. Once the rating is issued, the rating agencies shall continuously monitor and promptly disseminate any changes in it for lifetime. The review shall be carried on periodically. If there is lack of co-operation by the client, then the rating shall be done based on the best available information. The rating agencies shall continue to rate until any debt obligation is pending against the instrument. However, in case of winding up, merger, or amalgamation of the issuer company, the obligation to rate shall stand discharged. There have been instances where the rating agencies have failed to discharge the responsibility of reviewing properly. Some

studies have established that the agencies are not interested in reviewing as they have no further incentive in doing so.

The credit rating agencies are required to frame internal procedure and systems for monitoring trading of securities by its employees of its clients to prevent breach of the SEBI (Prohibition of Insider Trading) Regulations 1992, the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 1995 or any other law relevant to trading of security. Although SEBI grants freedom to the rating agencies to frame their own laws to regulate, an exhaustive model code shall help better in achieving the desired purpose. Interestingly, the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 1995 has already been repealed by the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003. The repealing regulation is more comprehensive in regard to the offences of the previous 1995 regulation, but the new regulation does not override the old one. Upon closer examination, the provisions of the 2003 amendment cover similar offences as the older 1995 regulation. Therefore, the newer regulation should have better overridden the older regulation, to give clarity in the matter. As the newer regulation does not override the old one, there may be situation where both the regulations may be attracted and may create a dilemma for the court.

The CRAs are mandated to disclose that their ratings do not constitute recommendation, the definition of their rating symbols and the rationale of their ratings. The board may call for information and such shall be furnished the specified or reasonable time. The periodic circulars, among others, shall be complied with and for the purpose, a compliance officer shall be appointed. Other obligations include proper maintenance of Books of Account, records, and keeping the information given by the client

confidential, except otherwise permitted in law. The regulation strictly bars rating of security issued by its promoters [Regulations 25-28, Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999].

***The power of SEBI to inspect, investigate and punish.[Regulation 29 – 33, Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999]***

The powers are listed in Chapter V and VI of the regulations. The procedure for inspection and investigation are laid out between Regulations 29–33. The purpose of right to inspect and investigate is fivefold:

- To ascertain proper maintenance of books of account, records and documents of credit rating agencies,
- Compliance with the provision of Securities and Exchange Board of India Act, 1992 and Securities and Exchange Board Of India (Credit Rating Agencies) Regulations, 1999,
- To investigate in complaints received from investors, clients or any other person concerned with the business of credit rating agencies,
- To investigate in the interest of investors or securities market.

A minimum of 10 days written notice is required to be given before investigation. Nevertheless, the board has the power to dispense with the requirement in the interest of investors. The rating agencies are in turn obligated to grant reasonably access of the premises to the inspecting officer, extend reasonable facility for examining any book, document, record, and computer data in possession and provide copies of documents or other materials. The inspecting officer is required to submit the final or interim report of the enquiry or investigation to the board, as soon as possible. The board or

the chairman shall consider the same and take action as may deem fit under The Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.

The detailed provisions of procedure in case of default (Regulations 35 – 42) has been omitted and substituted with the procedure laid out in Securities and Exchange Board of India (Procedure for holding Enquiry by Enquiry officer and Imposing penalty) Regulations, 2002. In case of default found in inquiry or investigation, the credit rating agency shall be dealt accordingly.

### ***Recent Amendments***

The Regulation 22 directs the credit rating agencies to take adequate steps to rectify the deficiencies, if any, in the auditor's report. The circular SEBI/MIRSD/CRA/Cir-01/2010, dated January 6, 2010 amends the regulation to include the provision to undertake internal audit. The internal audit shall be conducted semi-annually by Chartered Accountants, Company Secretaries, or Management Accountant with no conflict of interest. The audit shall include "operations and procedures, including investor grievance redressal mechanism, compliance with the requirements stipulated in the SEBI Act, Rules and Regulations made hereunder, and guidelines issued by SEBI from time to time" (SEBI/MIRSD/CRA/Cir-01/2010, 2010, par. 1(c)). The report shall include the methodology adopted and counts of violation of any by-law. The report shall be prepared within two months from the expiry of the six month period. In case of any deficiency found in the report, the directors shall take the required steps and send the Action Taken Report to SEBI within next two months.

The circular CIR/MIRSD/CRA/6/2010, dated: May 3, 2010, has made crucial additions to the already existing regulations. It was specially written keeping in mind the global financial crisis. The circular covers the Rating Process, Default Studies, Dealing with Conflict of interest, Obligations in case of Structured Finance

Products, Unsolicited Ratings, Disclosures, Implementation Schedule & Reporting, and Additional Disclosures. During the rating process the rating agencies are directed to keep the records that support the credit rating/review. These include summary of discussions, decision of the rating committee and quantitative rating model until five years after the maturity of the instrument. The default rates are required to be published by credit rating agencies along with the changes over time. The objective of requiring such disclosure is to help investors determine the performance of rating agencies and compare them. The circular mentions the calculation formula for calculating the default rate. The rampant conflict of interest problem has been revisited by SEBI. Now, the analysts are not allowed to take part in business development or marketing. Also, the employees, involved in rating process, along with their dependants cannot own the shares of the issuer. In structured finance products, along with all the other obligations, the track record of the originator and the details of the nature of the underlying assets need to be disclosed. In case of unsolicited rating, the name of the security shall be accompanied with 'UNSOLICITED' in the same font size. The agency will then be under an obligation to rate it during its life. The disclosure requirement has also been beefed up in multiple areas. Lastly, there are other additional disclosure options to the rating agencies post approval of its board.

### **RISKS WITH THE STRUCTURE**

There have been enormous laches in the behaviour of the credit rating agencies. It cannot be conclusively determined, if the products were mis-rated deliberately or ignorance led to the same. Yet, there is some major conflict of interests apparent from the structure of the agencies.

Although the regulatory structure in India can be largely termed as satisfactory, there are areas that require considerable attention. The unresolved areas are discussed below:

### ***Issuer Pay Model***

The issuer pay model requires the issuer of the securities to pay for their rating, rather than the investors, who read the ratings. This model is in stark contrast to the investor pay model, where the issuer of the securities were not charged for getting their products rated, rather the investors had to purchase the rating assessment from the credit rating agencies. The issuer pay model was first put in place to combat the increasing problem of free-riding. This overtly came with the development of photocopying technology. The possible role of Issuer pay model in the crisis has attracted a lot of criticism.

There are several reasons for not doing away with the present model. First, with the advent of internet and digitalisation of media, free-riding is an even bigger concern. Second, non-cooperation has been experienced while ‘unsolicited ratings’. Extending the analogy further, as against the present model where the issuers of financial instruments are interested in obtaining higher rating from one or two rating agencies (as required by regulation) and in doing so they tend to divulge all the important information, it might become very tough for all the rating agencies to obtain non-public information from the issuers of the instruments. The issuers may also face a lot of problems while dealing with multiple agencies. The investor pay model will result in loss in precious revenue and may result in rating agencies not being able to sustain themselves. Further, non-cooperation or failure to obtain soft information may result in improper rating. Therefore, it would be inappropriate to recommend the substitution of issue pay model with investor pay model.

Imposing direct regulation on the fee to be charged shall defeat the concept of free market. However, milder reforms can be justified on the pretext of the larger interest of the investors. The rating agencies can be left to freely determine the fee for their services, but the fee shall only be revised quarterly. The agencies would be compelled to stick to their determined rates. The quarterly time frame shall provide enough

flexibility to the rating agencies to revise their fee at convenience, at the same time it shall be rigid enough to dissuade flexible pricing to bargain with issuers. This will help to check the instances of ‘rate shopping’ which rampantly corrupted the whole rating process leading to the financial crisis. This would also help the issuers in selecting the right rating agency with transparency in the process.

### ***Unsolicited Ratings***

The market regulators and participants rely on the ratings of financial instruments such as bond and commercial paper for risk assessment. The ratings can seriously affect their marketability, financing costs, and loan amounts (Poon, 2003). Engaging in unsolicited rating is one of the most controversial practices of credit rating agencies. It is the assessment of credit quality “that credit rating agencies conduct without being formally engaged to do so by the issuer” (The Technical Committee of the International Organisation of Securities Commission, 2003, p. 15). It is claimed by the agencies that they publish ratings as there is demand in the market (Bai, 2010). Two important implications arise from not being formally engaged in rating the product: first, they are not paid for it and second, firms are often not very cooperative in disseminating information so the rating agencies have to rely on the general information available openly in the market to conduct research rather than soft (private) information.

The “unsolicited ratings do not appear to be empirically as favourable as solicited ratings” (Spatt, 2005, par. 20). It is rather used “to ‘punish’ firms that would otherwise not purchase ratings coverage from a particular credit-rating service”. The empirical researches have established that Japanese firms are given lower unsolicited ratings (Poon, 2003) and Fitch’s shadow ratings are downward biased against Asian and international banks (Banner, Behr, & Güttler, 2010). It has further been prominently established using endogenous regime switching model that the unsolicited rating would be higher, if they were

solicited and the solicited lower, if they were unsolicited (Bannier et al., 2010).

The reason afforded by agencies for lower unsolicited ratings is conservatism to rate unsolicited instruments highly owing to limited access to information (Bai, 2010), that is, owed to non-cooperation of firms or regulatory structure (regulatory induced opaqueness in banking sector) (Morgan, 2002). On the contrary, there have been recognized instances of “pure blackmail”. Hannover re, one of the world’s largest insurance companies, was approached by Moody’s to subscribe to its service in 1998. It had already subscribed to Standard & Poor’s and A.M. Best, so turned down the request. Moody’s responded by publishing unsolicited rating at Aa2 initially. Subsequently, the rating saw a collapse to Aa3 in January 2001, A2 in November, and Baa1 in March 2003. These were three to four notches down as against the rating by S&P and A.M. Best. Analysts were surprised by stock prices collapse of as much as 10%, without any justifiable information. Not surprisingly, Moody’s advised repeatedly that subscribing to its service would improve its rating (Bai, 2010).

In a later case, The Jefferson County (Colorado) school district (245 B.R. 151) issued bonds to take benefit of low interest rates. It subscribed to Standard & Poor’s and Fitch for rating assistance. Later when the bonds were issued, Moody’s published an article putting these bonds on “negative watch”, which led to cancellation of order by some investor and higher interest payment for others. A suit was bought against Moody’s claiming the move to be mala fide. Yet Moody’s successfully pleaded defence of first amendment protection (claiming their ratings to be merely opinion). These coercive occurrences are not limited to the above cited cases.

The Indian Laws on Credit Rating Agencies talk about unsolicited ratings. It is mandated for rating agencies to accompany the name with ‘UNSOLICITED’ and shall keep a watch on the rating for the lifetime. They are further required to disclose their policies, methodology, and procedure in detail regarding unsolicited rating.

In a welcome move, the rating agencies are also directed to disclose the extent of participation by the issuer, its management, bankers, and auditors in the credit rating process along with the information used and its source in arriving at and reviewing the credit rating. The move shall help in distinguishing genuine cases of information asymmetry. The agencies also need to keep the record of all the unsolicited ratings carried out in the last three financial years (circular CIR/MIRSD/CRA/6/2010, dated: May 3, 2010).

The regulatory structure is indeed very impressive, but can be effectively termed as a toothless tiger. Imagine an agency complying with all the measures of unsolicited rating. The law does not point towards the objectivity of the model to be used. Rather it just directs the agencies to preserve the model. Professor Claire. A. Hill interestingly observed, “Moody’s had been too eager to find a way for the instruments to be AAA; confronted with the discovery that their model that supported the AAA rating was flawed, rather than adjusting the ratings, they “fixed” the model so the instruments could continue to ‘be’ AAA” (Hill, 2009). It would not be wrong to suggest that such tweaking can be maliciously done, claiming it to be an error. In that case, as they have a model, though faulty, should provide them enough cover to avoid the default provision under the regulatory framework. The result would be that the credit rating agency will successfully argue immunity for being mere ‘opinion’.

Contrasted with solicited ratings, the rating agencies would have less purpose for compulsively downgrading the firm but may use model fixing to upgrade the rating. The Indian law uses differential approach of having mandatory rating from one or two agencies. The amendment in form of unifying the regime to two mandatory ratings shall act as deterrence to the practice of model fixation in case of solicited rating.

### ***Firewalling other services***

One of the major problems with the conduct of business by rating agencies is their providing

ancillary services in addition to credit ratings. The services may range from debt restructuring to risk management consulting (Bai, 2010). “The issuer may use the incentive of providing the CRA with more ancillary business in order to obtain higher ratings” (India Ministry of Finance, Capital Markets Division, 2009, p. 31). The rating agencies argue that they have established substantial firewalls to deal with the problem by not letting the analyst involved in the ancillary services to participate in the process of rating. “However, at an SEC hearing, one buy-side participant testified that she was aware of at least one instance in which analysts from a rating agency were involved in marketing advisory service to her firm” (Bai, 2010, p. 263). The claim that this problem does not exist falls flat in the face.

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 provides a single provision to deal with this conflict of interest. Clause 11 of the third schedule directs that “A credit rating agency shall maintain an arm’s length relationship between its credit rating activity and any other activity.” This has certainly been dealt insufficiently and a credible solution is eagerly awaited.

## CONCLUSIONS

The SEBI has responded to the alarming call and kept pace with the global trend for reform to the Credit Rating Agency laws. Yet, in line with other jurisdictions, the larger issue of liability of CRAs in case of failure to rate an instrument properly remains unaddressed. The rating by them is considered an opinion and therefore no liability accrues on them in case of loss incurred by any investor.

The major problem faced in view of their regulation is the lack of liability for CRAs for reckless rating, though they can be held liable for *mala fide* rating under other laws. They very successfully argued before the U.S Congress using very prominent lawyers that their rating is

just opinion and covered under First amendment of the American Constitution. The position is not different under the Indian Law. I see no reason why other service providing professions should be subjected to law for their omission in giving proper opinion but not CRAs. A typical case would be of a doctor who is subject to Consumer Protection Law (Consumer Protection Act, 1986) for wrongful advice. But the CRAs go scot free, claiming that they just give opinions and that they should not be relied. The rationale behind the desired liability is that had all the investors been so sophisticated to be in the position to determine the risks themselves, there would be no requirement of CRAs.

Affixing liability to the rating agency would be a prudent and a decisive step in checking the potential malfunctioning in the system. It would be a welcome move if SEBI leads the way in affixing liability to credit rating agencies for reckless rating. If they reap benefits out of the system then they should be ready to pay for being irresponsible.

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