

**July 25, 2019 Meeting of the Securities and Exchange Commission
Investor Advisory Committee**

Opening Statement

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*Discussion regarding the SEC approach to regulation in areas with limited competition
The case of the credit rating industry*

Good morning Chairman Clayton, Commissioners, IAC Chairman Sheehan, IAC Member Coates, other IAC members and fellow panelists. Thank you for inviting me to address the topic of regulation in areas with limited competition today.

I started to do research on credit rating agencies in 2007 – a fascinating, but frightening time. The housing market collapsed as the leading credit rating agencies massively downgraded structured finance ratings and the subprime mortgage crisis erupted into a global financial crisis.

Today, we will see how an industry that was heavily criticised for bad performance has been doing twelve years later. Surprisingly quite well. In 2017, NRSROs reported to the SEC a total revenue of approximately 7.1 billion dollars, in other words, they remain as profitable, if not more, than in the run-up to the global financial crisis.

In addition, the credit rating industry remains a highly concentrated one. The Big Three – Moody's, Standard & Poor's and Fitch – have continued to dominate the market totalling more than 90% of the market share. Why the shape of the industry has not changed much post-crisis?

It is worth noting that the industry is highly concentrated since its inception when Moody's issued the first rating in 1909. There have been historical and natural barriers to entry, comprising a first mover advantage and economies of scale. Since the 1970s regulatory barriers to entry have been added gradually – what is peculiar in the credit rating industry is the significant use of credit ratings for regulatory purposes, which has actually partly led to the lack of competition in the credit rating industry. It involves sort of outsourcing a quasi-regulatory power to credit rating agencies. The regulation artificially increased the demand for credit ratings and inadvertently elevated credit rating agencies to a crucial position up to becoming part of the international financial architecture, which culminated with international standards on bank capital requirements pursuant to the Basel Accords.

Having set the scene, the question arises as to how competition and regulation are intertwined. On the one hand, to what extent does the regulation affect competitive forces? On the other hand, can regulatory intervention actually introduce competition?

What I will do is to provide an overview of the major aspects of the reform post-crisis and assess the effect on competition in the credit rating industry. Three aspects are covered by both the US and the EU reforms.

First, increasing oversight; second, reducing over-reliance on credit ratings; third, introducing liability provisions. All three aspects may have an impact on the level of competition in the credit rating industry.

It is important to recognize the trade-off between regulation and competition. On the one hand, increasing oversight is needed post-crisis, but compliance costs are at the expense of competition. On the other hand, restoring competition is needed at least in terms of reducing mechanistic over-reliance on a handful of players. Reliance on a highly concentrated rating industry may even jeopardize financial stability.

Let us have a closer look at the extent to which the US and the EU have taken a similar or different approach regarding the interplay between regulation and competition.

In the US, the Credit Rating Agency Reform Act of 2006 set forth competition as a regulatory objective. The idea was to increase the number of NRSROs. However, the Dodd-Frank Act of 2010 has not followed the same path. Dodd-Frank does not mention competition as an objective of credit rating agency regulation. Nevertheless, the approach post-crisis aims to modify the competitive landscape by removing regulatory references to credit ratings. The idea is to move away with regulation that significantly contributed to the distortion of incentives in the first place. Downsizing the importance of credit ratings is expected to restore market forces.

Now, let us turn the spotlight on the EU framework. Why does it matter for you actually? The EU regulator ESMA is keen on tackling problems in the credit rating industry, including targeting the Big Three, which are US-based. The Credit Rating Agency Regulation is just one of the EU regulations that have an extraterritorial reach. To give you another example that you have got scheduled today is the impact of MiFID II on US broker-dealers. Numerous US regulated entities have to comply with regulations of a foreign jurisdiction such as the EU. This includes the US credit rating agencies when they issue credit ratings even of US securities, so long as the ratings ought to be used for regulatory purposes in the EU. Actually, the US credit rating agencies may want to have access to the EU market and that is why they subject themselves to EU regulation. In this context, access to the EU market consists of being able to sell regulatory licenses in the EU, i.e. having their ratings used for regulatory purposes in the EU. That is how it falls under the jurisdiction of the EU.

In the European Union, there was no regulation of credit rating agencies before the crisis. Regulation was adopted in 2009 and was amended so that now CRAR III of 2013 tightly regulates the credit rating industry.

There is an emphasis on competition in the EU framework. (i) Increasing the number of players and currently there are 29 credit rating agencies registered in the EU, (ii) requiring to consider to hire smaller credit rating agencies, which are those that have less than 10% of the total market share and (iii) regulating and supervising fees charged to issuers, which are just a couple of examples with respect to competition.

However, there are unintended consequences of the regulation because the increased oversight increases regulatory barriers to entry. The EU has recognized this trade-off and attempted to consider how to level the playing field between larger and smaller credit rating agencies. However, no efficient solution has been found yet in this regard.

The trend that has been observed post-crisis is that although regulators were supposed to remove regulatory references to credit ratings to reduce over-reliance, they have not achieved much in this regard. Instead, regulation at least in the EU has acknowledged the importance of credit ratings.

Nevertheless, I need to mention a key area where the EU has reduced the regulatory use of credit ratings: sovereign debt markets. Credit ratings were used to assess bank capital charges in accordance with the international standards, but when sovereign ratings of EU Member States such as Greece were downgraded, then the EU regulator stopped requiring that banks use credit ratings in the case of domestic sovereign exposures. By the way, currently the alternative is a 0% risk weight.

Apart from that, there are some signs that the EU has given up on further efforts to remove regulatory references to credit ratings. Part of the explanation is that this justifies the extraterritorial reach of EU regulation on credit rating agencies. So long as the credit ratings of the Big Three are used in the EU for regulatory purposes, the EU can continue to indirectly regulate them. Another rationale is that the EU perceives the credit rating industry eventually as a necessary evil.

As a consequence, the approach taken consists of strong oversight and supervision in a way that competition cannot effectively be restored in the EU. This is eventually a paradox. Setting competition as a key objective, but not being able to restore it because of continuously depending on credit ratings for regulatory purposes.

Therefore, this gives you a flavour of how different the two approaches are. While the US focuses more on reducing regulatory reliance, the EU's preference goes for more oversight. From the US perspective, this may result in inconsistency in the event US regulators succeed in deleting regulatory references to credit ratings, but US-based credit rating agencies assign ratings to US securities and get their ratings endorsed by their EU-based subsidiaries so that they end up being used for regulatory purposes in the EU. In a way, US-based credit rating agencies can continue the business of selling regulatory licenses in the EU to EU market participants that actually invest in US securities. The problem is that it may undermine the effectiveness of the Dodd-Frank Act provision that requires US regulators to do away with ratings-based regulation – a provision that aims to improve incentives, thereby increasing competition in the credit rating industry.

Last but not least, removing ratings from regulation requires to find the suitable alternatives in order to improve the industry. Just looking at the credit rating industry, the fix would be actually simple: getting rid of regulatory references would increase competition. That is 100% sure that it would create better incentives in the credit rating industry itself.

However, the problem is that it gets trickier because doing away with credit ratings will have a domino effect on other areas of the financial system. The alternative that is found, if it is not better, if it leads to more lenient regulatory standards in other areas, then it is also very problematic for the financial system as a whole. Two examples here: bank capital requirements and insurance capital requirements.

First, the alternative for bank capital requirements would be to use internal ratings, actually letting banks assess their own creditworthiness. And the last example: insurance capital requirements. Where there was successfully a move away from regulatory references to credit ratings and the alternatives used are assessments by PIMCO and BlackRock that have actually not led to tighter capital requirements for insurance companies but rather to more lenient alternatives as compared to

what the credit ratings would require in terms of capital charges for the insurance industry. This is the case in the MBS sector.

In conclusion, there is an absence of meaningful competition in the credit rating industry. Private market forces would not have placed credit rating agencies at the core of the international financial architecture if regulatory intervention had not artificially increased the demand for credit ratings. The problem is now that regulators have maintained credit rating agencies at the center of the international financial architecture. In that type of setting, regulatory intervention to increase competition may be misguided and may even have counterproductive effects. Finally, removing regulatory references to credit ratings has proven challenging.

Thank you for your attention and I look forward to hearing my fellow panelists as well as to our discussion.