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The quality of credit ratings and liability: The Dutch view

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ABSTRACT Credit rating agencies (CRAs) such as Standard & Poor's and Moody's have existed since the beginning of the twentieth century. Their main objective is to increase the efficiency of the financial markets, by producing ratings expressing the creditworthiness of companies with respect to loans and credits. The intermediary position of CRAs places high demands on the efficiency of the rating process and the avoidance of conflicts of interest. In practice there is some doubt as to the realism of these objectives and hence the usefulness of ratings even though, paradoxically, they do enjoy broad acceptance. This article discusses the question of whether the criticism that investors and companies have of CRAs is always justified, and what action should be taken when that criticism is justified. Reference is made to the objectives of CRAs and the doubts about their efficiency and effectiveness that have arisen in many national and international publications. This article provides an insight into how CRAs operate and how this is judged within a society. CRAs have an information transformation function, and the existence of dual information asymmetry might have a negative impact on this. Holding CRAs liable is one of the possible solutions. Legal measures, such as breach of contract and negligence, may offer CRAs incentives to make every reasonable effort to prepare adequate credit ratings and to update ratings in a timely manner. It is nonetheless difficult (in the context of liability) to make an objective assessment because CRAs, too, must work under uncertain relationships.

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INTRODUCTION

Credit rating agencies (CRAs) develop opinions on the general creditworthiness of issuers

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or obligors, on behalf of investors in loans of companies, semipublic bodies and countries. They do so on the basis of quantitative and qualitative analysis of the financial strength of issuers. Standard & Poor's (S&P's) Credit Market Services, Moody's Investors Service and Fitch Inc. are some of the more familiar names of American CRAs. Inevitably, these agencies

provide their opinions under conditions of uncertainty and risk because even CRAs do not have prophetic powers. Their roots go back to the beginning of the twentieth century. The agencies are expected to contribute to the efficiency of the financial markets. The CRAs have been under fire for some considerable time now because of the fact that ratings issued on leading companies later turned out to be incomprehensible. However, their demonstrable and widely alleged failure during the period 2007–2009 in particular cannot be considered as imputable without qualification. Failure is not by definition culpable failure. In addition to CRAs, there were also many other actors in the financial world who made not insignificant mistakes in the run-up to the financial crisis of 2007–2009, such as banks, investors, governments and regulators. This realisation means that CRAs and their actions must only be judged against the background of this ‘collective failure’ of the financial system, even if it is an established fact that in retrospect entirely incorrect ratings were issued at the time.

There is no doubt that CRAs are partly to blame for the credit crisis, which broke out in the summer of 2007. This is the opinion of US professor Frank Partnoy (Den Brinker, 2008), who believes that there is strong evidence of culpable negligence. Others call the integrity of the CRAs into question. In retrospect, excessively high ratings were repeatedly issued for financial products, which in no way deserved them. This has come to be known as the phenomenon of ‘inflated ratings’ (cf. Opp *et al*, 2011). The emergence of structured financial products (such as asset-backed securities) in particular led to the CRAs earning vast amounts of money. As already mentioned in the introduction, the quality of the ratings was not guaranteed (Bar-Isaac and Shapiro, 2010). After the credit crisis broke out in July 2007, these financial products were found to have only a fraction of their original value, whereas the associated ratings continued to indicate they were of the highest quality. The relative

independence of the CRAs from their clients would appear to have been a major contributory factor in this regard. Some people suspect that while evaluating the ‘creditworthiness’ of issuers and their products, the CRAs knowingly ignored the risks the issuers were so keen to conceal. The fact that the CRAs act not only as advisors, but also as evaluators raises questions about the objectivity of credit ratings.

On the other hand, as previously mentioned, CRAs are a part of the large global financial system, which failed as a whole to prevent the aforementioned financial crisis of 2007–2009. It is relevant to ask which mechanisms made a significant contribution to the origin and the depth of the crisis. Were issued ratings, which were subsequently found to be erroneous, ‘merely’ mistakes on the part of the CRAs, which can always occur in the financial sector, or did CRAs abuse excessive discretionary powers granted to them under a regulatory regime that had been imposed by the US authorities? This is the central theme of this article. The purpose of this article is to identify the backgrounds and causes of the qualifications referred to above and to examine whether liability under civil law on the part of the CRAs offers a solution in this regard. We will begin by explaining briefly what CRAs and credit ratings are precisely (paragraph 2). This is followed by consideration of the accusations directed at CRAs by regulatory authorities (paragraph 3). The fact that the CRAs have (repeatedly) been placed in a negative light would appear to suggest a ‘systemic failure’ rather than mere coincidence. Paragraph 4 includes a brief summary of the theoretical and empirical literature on the subject of CRAs. In paragraph 5, we examine the systemic failure referred to above from a legal economic perspective, and this reveals that the rating market is characterised by ‘dual information asymmetry’ in all current relationships between the three parties concerned. This can be traced back to the phenomena of ‘adverse selection’ and ‘moral hazard’. We will then argue that liability under civil law on the part of the CRAs offers a solution here (paragraphs

6 and 7), although we will also make an important qualification in this regard (paragraph 8). This is followed by an explanation of the duty to investigate which is incumbent upon CRAs (paragraph 9). We finish this article with a conclusion (paragraph 10).

WHAT ARE CRAS AND CREDIT RATINGS?

CRAs are companies that evaluate the credit risk of banks, insurers and other businesses. The debt securities and capital instruments of these businesses may also be the subject of a credit rating. The evaluation, or review, is translated into a credit rating, which is used by investors, among others, to evaluate the risk of a loan or its likely return (Duffhues, 2006a, p. 40). The higher the creditworthiness of a business, the higher the rating that is issued. S&P's, Moody's and Fitch are the three best-known and largest CRAs. S&P's and Fitch use a combination of letters and plus and minus signs to express the credit risk (for example, AA+). Moody's uses letters in combination with numerals (for example, Aa1). Creditworthiness is evaluated not only on the basis of the business risk (the degree to which the actual operating results may deviate from the expected operating results), but also on the basis of the financial risk (the degree to which the actual pre-tax profit may deviate from the expected pre-tax profit because of financing using loan capital). A credit rating includes a factual element and an element expressing a subjective opinion.

Different parties can take the initiative to draw up a credit rating. The company that is the subject of the credit rating can request the credit rating itself. This is referred to as a 'solicited' or 'requested' rating. A company requests a rating because this is frequently required in order to be able to effectively obtain access to the international capital market and large investors at the lowest possible interest cost.¹ The company pays for the rating in the form of a fee. An investor or the CRA itself can also initiate a credit rating. In that case the credit rating is 'unsolicited' or 'unrequested'. This

takes place in principle without consulting the company that is the subject of the credit rating and without the company concerned having to pay for the rating. Paragraph 4.4 examines the difference between requested and unrequested ratings in further detail.

CRITICISM BY REGULATORY AUTHORITIES

CRAs have been the subject of discussion with some regularity for many years in general, and more particularly in the light of the credit crunch. This paragraph briefly mentions several important sources of criticism without, however, claiming to be complete in this regard.

Securities and Exchange Commission (SEC) report (2003)

The US Sarbanes Oxley Act (2002) was promulgated with the principal aim of providing for better regulation of corporate governance than had previously been the case. The act included an instruction to the SEC to prepare a special study of the conduct of CRAs. As a consequence of this, the SEC issued a report on the role and operation of CRAs and it examined their importance to the financial markets. The preliminary report contained provisional results of the investigation into alleged practices intended to distort competition, the degree to which CRAs had discharged their obligation to use their best endeavours and the necessary regulation of CRAs (SEC, 2003). Among other things, the commission foresaw that more information was possibly required on the assumptions underlying the rating decisions made by the CRAs; that the distribution of ratings would be improved and that ratings would be accompanied by an indication of the party that had initiated the rating process. The report was prompted by the financial scandals at the beginning of this century surrounding companies such as Enron, which had gone bankrupt surprisingly quickly without the CRAs providing timely information to the investment markets. The commission reported

that improvements were needed with respect to the flow of information on their activities and the supervision of the conduct of CRAs in particular.

It is also worthwhile mentioning that according to this important report credit ratings were essentially seen as an ‘opinion’ of the CRA on the creditworthiness of a particular issuer, or debtor, at a particular date. For many decades, market players have relied on these ratings to form their judgement on the financial quality of securities. Mindful of the importance of the proper functioning of the financial markets, regulatory bodies therefore demanded that the rating process should be careful and meticulous.

Partnoy’s contribution (2006)

Partnoy (2006) characterised the CRAs as ‘the least-understood gatekeeper’ of the financial markets. This author emphasizes the harm to the ‘reputation capital’ of CRAs in all cases in which these ‘agents’ of the financial system issue poor ratings. The culpability of CRAs is also qualified in terms such as ‘in the period 2001–2006 CRAs performed no more poorly than other gatekeepers’. He specifically highlights the potential conflicts of interests and the oligopolistic structure of the market in which they operate. CRAs enjoy protection from the regulatory authorities, and hence also enjoy an advantage when they perform poorly. An important feature is that CRAs, unlike other gatekeepers such as accountants and lawyers, are largely immune to civil and criminal liability if a party is disappointed in its expectations. Partnoy considers this relative protection to be unjustified. Courts have ruled that ratings are nothing more than opinions. Partnoy considers this to be an error of the American legal system. According to Partnoy, CRAs are controversial because although they are important they add little informational value. He characterises CRAs as paradoxical institutes. Improvements must stem from CRAs offering more information and from limiting their influence on the financial markets.

The Committee of European Securities Regulators (CESR) report (2008)

The CESR has also set out its criticism of CRAs in a consultation paper (CESR, 2008). According to the report, until recently the ratings provided by a CRA were considered to be very reliable. However, the CRAs are held largely responsible by many for the recent turmoil in the (financial) markets. Four shortcomings attributed to the CRAs in the CESR’s consultation paper are listed below.

- (a) The first shortcoming is the limited transparency towards the market of the rating activities of CRAs in general, and the rating methods in particular. The complexity of so-called structured financing products caused problems to investors. Investors were therefore inclined to rely too much on the credit ratings. The credit ratings were hence used for purposes for which they were not suited (CESR, 2008, p. 25). The CRAs – knowingly or otherwise – allowed investors to believe that credit ratings could be used as a guide when making investment decisions.
- (b) The second shortcoming concerns the personnel policy that CRAs had pursued. The capacity of the CRAs and the quality of the analysts was inadequate. According to a Dutch author, Dekker, far too few analysts were available to perform the work (properly) (Dekker, 2008).² Complicated jobs were also assigned to inexperienced analysts. Furthermore, CRAs neglected the education and training of their analysts.
- (c) The third shortcoming concerns the inadequate ‘monitoring’ of the credit ratings by the CRAs. It was repeatedly found that it took a very long time for the CRAs to update their credit ratings, particularly when negative developments necessitated a ‘downgrade’. Timely information gathering and timely adjustment of the rating are necessary, however, to maintain the

valuable, current and informative function of a credit rating.

- (d) The fourth and final shortcoming attributed to the CRAs concerns the high degree of dependence of the issuers on the CRAs. CRAs provided a credit rating to financial instruments in relation to which they themselves had previously advised the issuers. This results in conflicts of interests. The issuers considered a high credit rating to be of essential importance. The CRAs were therefore asked, before the credit review, to advise on the requirements, which the product would have to meet in order to obtain a good credit rating (further details in this regard are given in paragraph 4). Increasingly, CRAs 'wore two hats': that of an adviser and that of a credit rating evaluator. The Dutch author Bartjens has formulated this in terms of the CRAs having allowed themselves to be guided too much by the wishes of the issuers (Bartjens, 2009).

Recent criticisms and developments (2010)

Theorists have been joined by politicians in criticising the role of CRAs, particularly since the outbreak of the financial crisis. Their ratings with regard to subprime instruments were stamped triple-A, even though they have since sunk to junk status. Barroso, president of the European Commission, recently commented (Tait, 2010a) that 'ratings appear to be too procyclical, too reliant on the market mood rather than on fundamentals'. He said that stricter rules to avoid CRAs becoming entangled in a conflict of interests were urgently needed, as was greater clarity regarding the methodology of the rating process and the fee income earned by the CRAs. A committee of enquiry of the US Congress recently reported that it had been established that the two largest CRAs had been unreasonably influenced by investment bankers who had paid them commission to issue ratings on Collateralized Debt

Obligations (CDOs). It has been shown, furthermore, that CRAs continue to receive fees even when it is already evident that the previously issued rating was not correct (Gapper, 2010). Leaving this discussion of rewards to one side, the question arises whether the CRAs respond to the financial markets or vice versa. Moreover, there are signs of a certain aversion in Europe for the current leading American CRAs and their working methods. Brussels is considering setting up a home-grown European rating agency, possibly specialised in rating government loans (Tait, 2010b). In any event December 2010 will see the introduction of already stricter regulations by Brussels in relation to the commercial practices of CRAs. These regulations relate in particular to the requirement that these CRAs and the methods they use be registered.

The leading Western CRAs (Moody's, Standard & Poor's and Fitch) have very recently also come in for criticism from Chinese CRAs who regarded their colleagues as having caused the financial crisis. One point of this criticism is that China should have more influence on the rating process as the country has enormous funds entrusted overseas, also to governments.

There was criticism, among other things, of the phenomenon of 'rating shopping' by companies looking for the most favourable rating among different parties in the business sector. Western CRAs were also accused of political bias in relation to the United States and the United Kingdom (Anderlini, 2010).

ACADEMIC LITERATURE

Boot (2006) has pointed out the difference in appraisal CRAs receive from practitioners and academic literature. Where practitioners are mainly positive in their appraisal, literature is predominantly negative in its assessment. The practitioners attached great significance to the actual use of ratings by financial market players and regulators. Literature focused more on seeking the theoretical significance

of CRAs, and failed to find it. Since March 2006, the global financial crisis of 2007–2009 and the role that CRAs played in this crisis have made clear that literature generally got it right by displaying a considerable degree of scepticism as regards the added value of CRAs: huge losses have been suffered by investors who were put on the wrong track by poorly and inadequately substantiated ratings issued by the well-known CRAs in the United States. This does not establish the degree of culpability, however, as was maintained in the introduction.

In his article from 2006, therefore dating from before the financial crisis, Boot (2006) drew attention once again to the lack of a theoretical framework for assessing credit ratings. He proposed plugging this gap by developing the view of ratings as a coordination mechanism in fragile financial markets (Boot *et al*, 2006). The primary focus in this theoretical framework is more particularly on coordinating the conduct of investors rather than of the CRAs themselves. The secondary focus is on controlling the behaviour of companies issuing securities. In this sense ratings contribute to the stability of the financial markets.

The traditional CRA model

In the traditional model investors beneficially use ratings as a beacon to aid their investment decisions, as these ratings reduce the unavoidable information asymmetry that exists between company and investors. This is where it is assumed that the CRAs add value. The expectation is that financial markets work better as a result. In this view, the costs of the financing to be obtained are lowered because keener and better decisions can be made on the price of a loan. On the other hand, investors can also increasingly follow their own course because the quality of the information is generally greatly improved for all parties thanks to the development of technology. For this reason the scope of the CRA's activities would therefore have shrunk. Their role would have lost some of its importance.

According to Boot (2006), the empirical study has been unable to prove that this traditional CRA model is right – that it contributes to a more transparent market. This could suggest that investors have taken up the reins themselves and have less need of the CRAs, who have, as it were, become victims of technological development. In our opinion this merely seems to be so. Rather, the opposite is true. In reality, investors were and are unwilling to turn their backs on ratings, although investors too are once warned twice shy. We have identified at least three reasons why CRAs will not be easily threatened in their continued existence. First, financial globalisation has only served to increase the importance of ratings. Investors around the world must make decisions on the quality of issuers of securities who may be based far away in another country or even another continent, and they make extensive use of ratings to help them in this process. Second, the wave of innovation on the financial markets that has led to the introduction of often highly complex products has greatly strengthened the need for ratings. Not every investor is willing to delve into the details of complex products and is therefore inclined to follow ratings of recognised CRAs. A third possible explanation for an increased interest in ratings is the series of financial scandals that have occurred from time to time over the past decade in the international business sector, and which have had an adverse effect on the quality of corporate governance. Investors will want to use ratings to continue to arm themselves as effectively as possible against any abuse of their good will when subscribing for issues of shares and bonds.

The conclusion is surprising in the sense that the traditional CRA model was, on the one hand, doomed to die a slow death because of technological developments whereas, on the other hand, certain developments and the behaviour of actors in the interplay of forces in the international economic arena have actually substantially increased the need for ratings. The need for ratings provided by expert CRAs acting with integrity is even greater than ever

in spite of the technological developments. The role of the CRAs has hence increased rather than withered away. Their power has also effectively increased rather than declined. Nonetheless, their precise role is unclear and is a long-standing subject of study, all the more as even the integrity of these institutions is now in dispute.

The coordination mechanism (BMS) model

As far as is known, Boot *et al* (2006) were the first to seek a real explanation for the existence of CRAs. Their 'coordination theory' can be summarised as stating that these CRAs fulfil a coordinating role in relation to the behaviour of investors and companies. They act as a compass, as it were. For investors who are obliged to comply with restrictive ancillary conditions in order to be allowed to invest in certain quality bonds in particular this compass function is, all things being well, a 'light beacon' in the enormous flow of information threatening to engulf investors on a daily basis. Companies too have a need for the compass of the financial markets that is provided to them by the CRAs.

The information transformation model

For many years now, academic literature has been unsure of the correct answer to the question of whether CRAs are not simply serving up yesterday's news reheated. It is argued that what ratings express is generally already visible in the financial markets and already incorporated in the price, and is therefore more or less repeat information and hence superfluous. If this is true, the costs of financing are no lower thanks to the ratings, whose role is to provide greater transparency, but are just as high as without ratings. In that case, strictly speaking ratings have no value whatsoever. This view of CRAs fits in with the theory of the efficient market, which immediately incorporates all relevant information that is in the public domain into the price of securities and financial techniques such as hedging instruments. The

question, however, is whether CRAs, in addition to basing their analyses on information that is publicly available, do not also to a large extent carry out analyses on the basis of information that they themselves have created, as well as inside information, that they have obtained in the financial network. Given their central role in the financial markets, their considerable professionalism and their existing networks, this can certainly not be discounted. If and to the extent this is correct, then CRAs undoubtedly have the effect of increasing the scope of information, thereby justifying their existence. In that case they make the market more information efficient by transforming *inside information* into public information. We refer to this as the *information transformation function* of the CRAs. The coordinating role of CRAs introduced by Boot *et al* (2006) is in effect the embodiment of this information transformation function. This approach therefore ties in with the task set out above of transforming inside information into public information. The cost of bond loan capital to be raised is directly related to the rating. The potential empirical contribution of the information transformation model can be substantial mainly because of the fact that it appears to be readily consistent with the consequences of CRAs applying the credit watch procedure. If a company is placed on the Watch List – in other words: the CRA believes that there are grounds for increased vigilance and this fact is published – then there is an immediate and significant negative effect on the price. This simple report is more informative than the later lowering of the credit rating itself. We interpret this as a demonstration of the transformation of inside information into public information, which occurs as soon as a new name appears on the Watch List. The coordination theory is not contrary to the information transformation theory, rather constitutes its practical implementation. It is important to note in this regard that in all this the integrity of the CRA itself – without any conflict of interests – may not be in dispute. In practice, not everyone

is convinced of this integrity because of the danger of a conflict of interests as a result of which the authority of the CRAs has been undermined and a false sense of security was held out to investors. The reason is that in traditional literature CRAs are wrongly seen as institutions which, as intermediaries, do not create problems of their own (Boot, 2006). However, the pursuit by CRAs of their own interests can provoke deviant behaviour. The CRAs also have their own commercial goals. They will, however, seek as far as possible to avoid any damage to their own reputation.

Boot (2008) mentions an interesting example of possible undesirable behaviour: the unsolicited rating.

Solicited and unsolicited ratings

Theoretical and empirical literature alike reserves an important role for the distinction between solicited and unsolicited ratings, and their consequences for assessing the conduct of CRAs. Do these agencies act out of a certain degree of market strength, and therefore of a perverted enjoyment of power, or merely on the basis of adverse selection? A third possible explanation is that issuers decide themselves whether or not to request a rating, the consideration being that they will do so if they think that an unsolicited rating will wrongly prejudice them. Higher quality issuers will request a rating; the weaker issuers will not. This leads to three possible explanations in total. Unsolicited ratings extend the range of the CRAs' activities and send out a signal to the market players. As in this case no examination of the issuer's books takes place, the transformation of information that is determined by the passing on of public information will, in principle, be restricted. The credit rating agency can, however, also express its general network-based know-how in an unsolicited rating (see subsection 'The Committee of European Securities Regulators (CESR) report (2008)'), so that information is nonetheless produced for outsiders. The economic function is then consequently limited, but still useful to investors. Things are different

for the prospective issuer. Prospective issuers generally feel that unsolicited ratings are too low, thereby increasing their interest burden. It is therefore hardly surprising that issuers will in the second instance ask the agency for a rating so as not to be worse off. This demonstrates that a CRA can effectively enforce a solicited rating by issuing an unsolicited rating. The CRA gains a poor reputation as a consequence (Bannier *et al*, 2010). Academic research has shown that unsolicited ratings are generally lower than solicited ratings (Byoun and Shin, 2002; Bannier *et al*, 2010). Bannier *et al* (2010) refer to this as the 'downward distortion' of unsolicited ratings.

The first explanation refers to market strength or 'extortion' (Boot, 2008) of a rating that is subsequently requested. This is difficult to demonstrate, and has hardly ever been demonstrated (Frost, 2006).

The second explanation given is that CRAs are cautious or conservative in issuing an unsolicited rating because they simply want to be careful and do not have all that much information at their disposal; their reputation is additionally at stake, because the chance of wrongly estimating the default is greater than with a solicited rating. They guard against this by setting a relatively low rating, without any ulterior motive of extortion: it is a matter of 'adverse selection', its price is a lower rating. This second explanation is confirmed empirically in Gan (2004), who studied American companies, and by Bannier *et al* (2010) in relation to the ratings of industrial companies and banks. However, no evidence of conservative behaviour on the part of CRAs was found in the case of insurers. Self-selection played no role in the case of industrial companies and banks. The third explanation referred to – the self-selection argument – was not excluded in the case of industrial enterprises.

The study carried out by Bannier *et al* (2010) involved a random sample of non-American companies over the 10-year period, 1996–2005. These authors also found that unsolicited ratings were lower than solicited ratings.

The question arising from these studies is whether regulators and legislators should permit unsolicited ratings. They are controversial, after all. In Japan, in particular, unsolicited ratings have come in for sharp criticism from companies because of the pressure they exert on them to subsequently request a fee-carrying rating (Byoun and Shin, 2002).

Frost's review (2006)

Frost (2006) examined whether the criticism of the CRAs as set out in the SEC (2003) report referred to above is valid. To this end empirical research was carried out and other means were used to establish the truth. The author refers somewhat surprisingly to the limited empirical support for the substantial criticism levelled at CRAs, but adds that this type of research is characterised by problems with the design of the research and subjectively chosen benchmarks against which the conduct of CRAs is tested. Therefore, the results of the research cannot be interpreted without qualification as showing that the criticisms are unjustified. What is established, however, is that the dual role played by CRAs gives rise to a built-in system of conflicting stimuli and incentives. The disadvantages this entails may nonetheless be acceptable if there are no cheaper alternatives available. Frost concludes that better research must be carried out into optimum CRA conduct by means of modelling.

Conclusion

The economic function of CRAs is one of information transfer from an inside world to an outside world. In this article, this is referred to as the information transformation function of CRAs. By performing this function, CRAs coordinate the decisions of investors and the conduct of the issuers of loans. This characterisation does not conflict with the traditional view of CRAs as it presents information asymmetry precisely as the central problem area. However, the practical functioning of CRAs differs from this theoretical model, which, although may be useful in itself, is nonetheless too partial.

The reason for this is that CRAs create new information problems themselves. Information problems are partly rerouted by CRAs from the source of the shortage of information (issuers and investors) to the information solvers (the CRAs) themselves. Unfortunately, no work is currently being undertaken to develop a theory in relation to this topic (see Boot, 2006; Frost, 2006).

DUAL INFORMATION ASYMMETRY

The compass function of CRAs – the coordinating role they fulfil with regard to the conduct of investors and companies – also has a drawback. Information asymmetry exists between the CRAs, on the one hand, and the companies and investors, on the other hand.

The parties involved have a so-called principal–agent relationship. Information asymmetry is a common phenomenon in relationships, which are entered into by gatekeepers. The agent (CRA) is responsible on behalf of his principal (issuer in the case of a solicited rating; investor in the case of an unsolicited rating) for performing a particular task (here: preparing a credit rating) and for the interests of his principal, but it also has its own, possibly different, interest. However, because of the phenomenon of information asymmetry – the agent has information at its disposal to which the principal does not have access – the principal is unable to properly judge and verify the latter. What is so special about the principal–agent relationship in the context of credit ratings is the existence of *dual* information asymmetry (see Figure 1). The principal (investor or issuer) too sometimes has essential information at its disposal, which the agent (CRA) does not have. This dual

Figure 1: Diagrammatic representation of the dual asymmetry problem.

information asymmetry can lead to problems when arriving at a rating and also in respect of the quality of a credit rating. Information asymmetry can occur before (*ex ante*), as well as after (*ex post*), the credit rating agreement has been concluded. Information asymmetry results *ex ante* in the phenomenon of 'adverse selection'. The phenomenon of 'moral hazard' arises *ex post*. We will look at this briefly below.

The *ex ante* relationship between issuer and CRA (adverse selection)

Ex ante, in other words: before or on entering into the rating agreement, the issuer, as well as the CRA, each hold 'hidden information' (De Bos and Slagter, 2008, p. 22).

On the one hand, the *issuer* has an information advantage because he has access to company information, which is essential for preparing a credit rating. In terms of this information the CRA is dependent on what the issuer is willing to provide it with. The issuer will possibly attempt to convert this information advantage into a personal advantage by means of strategic behaviour (Weterings, 2007, p. 55). By providing incomplete or distorted information, the issuer can attempt to paint a rosier picture of its financial situation than is really the case. This may have the effect of boosting his credit rating. This higher credit rating will result in a lower interest rate (for loans).

On the other hand, the CRA has more knowledge about and information on providing credit ratings than the issuer. This advantage in terms of information and knowledge is strongly related to the form of information asymmetry referred to above. Armed with this advantage, the CRA will want to bind the issuer to it in order to be able to generate (even more) income (in future) from this relationship. The emphasis in the relationship can then, either consciously or unconsciously, come to be placed more on client-friendly ratings and on client bonding, than on producing good quality credit rat-

ings. The CRA feels less incentive to examine thoroughly the business information provided by the issuer for its completeness and/or accuracy. If the CRA bombards the issuer with too many (awkward) questions, the issuer may possibly decide to approach other CRAs for a credit rating in the future.

The third party, the *investors*, recognise that hidden information may exist, although they do not know whether hidden information is used in a specific instance. Nonetheless, investors are generally aware of the risk that issuers and CRAs will attempt to benefit themselves as a result of the information differences described above. This insight has consequences for investors' attitude towards issuers and the conditions under which they are willing to invest. In many cases, investors are unable to distinguish between good and bad capital seekers. The impossibility of distinguishing between capital seekers who deserve a good credit rating and capital seekers who do not deserve a rating that has been given means that investors consistently demand additional risk compensation on top of the interest (Duffhues, 2006b, p. 119). Issuers with a high credit standing therefore pay more interest than if investors were aware of their actual creditworthiness. These issuers then opt for a superior source of finance, one which does reflect their high credit standing in terms of a low(er) rate of interest. This results in the adverse selection problem: bad capital seekers squeeze good capital seekers out of the finance market. A 'skimming off process' follows, with the best capital seekers leaving the market each time until eventually only bad capital seekers are left over. The interest benefit from using credit ratings eventually disappears, with demand for the services of CRAs declining as a result. The pursuit of short-term profits by issuers and CRAs 'over the backs of investors' eventually causes their downfall. For this reason parties should be stimulated whatever happens not to use *ex ante* their advantage in terms of (knowledge and) information so that the risk premium incorporated in the rate of interest will fall.

The ex post relationship between issuer and CRA (moral hazard)

Moral hazard relates to the danger that the CRA, once the agreement has been concluded, will behave differently when implementing the agreement than may reasonably be expected of it. This danger is facilitated by the CRA's advantage in terms of knowledge and information relative to the issuer with regard to the provision of credit ratings. As a result, the CRA's performance (having regard to the issuer's interests) may fall short without this being noticeable to the issuer or it being in a position to remedy the default (Duffhues, 2006b, p. 119). The lack of openness about the CRA's rating activities and rating methods towards the market contributes to this. If an issuer does (partly) notice that the CRA is not strongly inclined to use its optimum endeavours on behalf of the issuer's interests, or indeed: that the CRA is failing in its performance, then the issuer may lack the possibilities and means to intervene. The issuer is then unable to stimulate the CRA to provide high-quality ratings, objectively viewed.

In spite of the CRA's information advantage, with the danger for the issuer that the CRA will not use its optimum endeavours on behalf of its interests, the rating activities can and will often work out (too) well for the issuer because of the existence of a financial relationship of dependency. The CRA is paid by the issuer ('subscriber-pay'). This dependency contributes to the fact that downgrades of credit ratings do not take place in a timely manner, or do not take place at all. If the CRA deals too harshly with the issuer, there is a possibility that the issuer will turn to a competitor in future. This cautiousness on the part of the CRA towards its principal can affect the actual value of the credit rating. The CRA then goes too far in its attempts to please the issuer. However, the existence of information asymmetry ensures that the issuer is also unable to notice and remedy a rating that is too high, even if it wished to do so. Although the possible influence of the relationship of dependency on the

quality of the credit ratings that have been drawn up may in principle work in the issuer's favour in the short term, the same cannot be said for the medium to long term. A credit rating that insufficiently expresses the present position (too high) works to the detriment of investors. They pay too much interest. This detriment translates into damage to the reputation of issuer and CRA alike. As a result, investors will demand an additional 'spread' in future before they do business again with this issuer or any other issuer.

In paragraph 5.1 it was stated that the impossibility of separating good capital seekers from bad capital seekers in the ex ante situation (adverse selection problem) implies that investors will, as a preventive measure, demand additional risk compensation. Because of the reasons set out above, investors also take a similar approach relative to the moral hazard in the ex-post situation. Although there may possibly be an (limited) interest benefit to the issuer in the short term, this is cancelled out in the long term because of the distrust of the investors. At the end of the day, a rating that is as realistic as possible is in the interest of the issuer and the CRA and the investors alike. It is debatable, however, whether this will actually be achieved as the CRA may emphasize its short-term interest over the long-term interest. The CRA must therefore be encouraged in one way or another to produce good quality ratings.

The ex ante relationship between investors and CRA (adverse selection)

Information asymmetry also exists between the CRA and the investor. In this relationship the CRA has an ex ante information advantage with respect to the evaluation of the creditworthiness of companies and issues (Duffhues, 2006b, p. 116). In the proposal for a regulation on CRAs, the Commission of the European Communities (2008) stressed that many investors are dependent on CRAs because they do not have the expertise and means

(time and money) to determine themselves the creditworthiness of the issuer or the issue. CRAs will attempt to use this knowledge advantage to achieve lower costs. Costs can be saved by economising on the intensity and duration of the investigation linked to the production of a credit rating. CRAs also have an information advantage. Although issuers are obliged to disclose price-sensitive information immediately (under Section 5:25i, subsection 2 of the Dutch Financial Supervision Act (Wft), for example), CRAs appear to have unique access to information (Boot, 2006, p. 110). The reason is that CRAs have access to 'first hand' business information. Barring unsolicited ratings, it is the issuer that supplies the information directly to the CRA. The CRAs are closer to the source and can therefore access information more quickly, and in greater quantities and depth, than investors. CRAs will attempt to use this advantage in terms of knowledge and information to achieve lower costs. Because of their lack of expertise and means, as well as the fact that they do not have all the information used at their disposal, it is difficult for investors to check a credit rating for accuracy and completeness. The added value for the CRA then consists in the costs savings achieved. In an 'issuer-pay' situation, the CRA is not able to seek profit maximisation in the relationship with the investor as the company that is the subject of the credit rating (the issuer) pays the CRA for the services provided.

The pursuit of cost savings can affect the quality of the credit ratings, because the quality of the rating products is closely related to the thoroughness of the investigation that is carried out before a credit rating being prepared. Where cost saving efforts by the CRA lead to a disconnect between the credit rating and the actual credit standing, the CRA has abused its information advantage to the detriment of the investor. It is very possible that the investor will suffer loss or damage in the short term because of the more favourable credit rating for the issuer.

The ex post relationship between investors and CRA (moral hazard)

There is a conflict of interests between CRAs and investors in the ex post relationship, after a credit rating agreement has been concluded, also. For investors, it is a matter of high priority that the credit rating be continually updated. This entails additional research costs for the CRA. The CRA may make cost savings its priority. A consequence of the 'issuer-pay-model' is a lack of desired independence of the CRA relative to the interests of the investors. This lack of independence leads to the creation of the moral hazard. There is a danger that credit ratings produced in the past will not be adjusted when necessary to ensure that the credit rating remains up-to-date. An 'update' of a credit rating will mainly be omitted where there is a change in the circumstances that have a negative impact on the credit standing of the issuer. Investors can suffer loss or damage because of a CRA's failure to 'downgrade' a credit rating. The moral hazard exists if the investors are not able to check the CRA's actions. The actions that a CRA takes in relation to rating activities, and a possible failure in this regard, are generally hidden from the gaze of investors. Investors then fail to notice that the credit rating has not been updated. Where an investor is aware of a CRA's failure to act, it will often have no possibility of correcting the CRA.

The relationship between issuer and investor

CRAs justify their existence by reference to the information asymmetry between providers of (equity and loan) capital, on the one hand, and (the management of) the issuer, on the other (relationship 3). The objective of credit ratings is to reduce this information asymmetry by informing the providers of capital, and keeping them informed, of the expected developments. CRAs save investors work by incorporating the business information that has been collected into a credit rating.

In summary and in conclusion it can be stated that CRAs are in a position, within

certain limits, to exploit information advantages relative to the issuers, as well as to the underlying investors ex ante and ex post, with a short-term perspective. In the long term, however, this has a counter-productive effect on all three parties involved (damage to reputation). The incentives to pursue short-term interests in the relationship between issuers and CRAs must therefore be corrected as much as possible. Holding CRAs liable is one of the possibilities in this regard (see paragraph 6).

CIVIL LIABILITY OF CRAS AS A GENERAL SOLUTION TO THE PROBLEM

It follows from the preceding paragraph that the information asymmetry that exists in the relationship between the CRAs, on the one hand, and the issuers and investors, on the other, means that CRAs are not inherently sufficiently stimulated to produce high-quality credit ratings and to adjust the ratings in a timely manner. In the long term, however, a good rating is in the interest of all parties (given the risk compensation demanded by investors). CRAs and issuers will not always share this view, given the short-term profit benefits accruing to them in the case of a high rating. The question then is how to offer CRAs a greater incentive to produce adequate credit ratings and to update ratings in a timely manner. According to some, competition, reputation and civil liability can act as (additional) incentives to CRAs to produce high-quality ratings. We will discuss these control options below.

More competition

The three large CRAs – S&P's, Moody's and Fitch – encounter very little competition from other CRAs, although there does appear to be some competition between them. Empirical research has found that on average Fitch provides/provided structurally higher credit ratings than its competitors, which are larger and have been active on the ratings market for longer (Coffee, 2006, p. 300). This finding can be explained by reference to the belief

that issuers must be offered an incentive to go 'shopping' amongst CRAs. This incentive can be in the form of lower fees, for example, or a more attractive credit rating (Coffee, 2006, p. 300). In spite of their strong position, S&P's and Moody's will not be entirely oblivious to their competitor's moves. Mindful of the need to preserve their revenues, they may make concessions with regard to the quality of the credit ratings they produce, or at any rate feel an incentive to do so. This may possibly result in higher credit ratings. Becker and Milbourn (2009, p. 27) refer to this development aptly as follows: 'competition is associated with friendlier ratings'. Increasing competition in this sector is therefore not an appropriate incentive to get CRAs to produce high-quality credit ratings.

Damage to reputation

Various authors believe that the possibility of damage to their reputation does constitute an appropriate incentive to CRAs. The fear of damage to their reputation should ensure that CRAs will make sufficient efforts to prepare good quality ratings (Vincentelli, 2007, pp. 18, 28). Even though the reputational effects will certainly be of importance to CRAs and will be a reason why they will also adjust ratings, actual practice teaches us that reputation alone offers insufficient incentive and that additional incentives are required, or at any rate are not superfluous. CRAs slipped up on various occasions before and during the credit crisis. Earlier, too, such as before and during the Enron affair, CRAs made comparable errors with regard to ratings. The resulting damage to their reputation has been minor, given the trust which still existed, until shortly before the start of the financial crisis, among issuers and investors in the CRAs and their rating products. The minor influence of reputation is probably also attributable to the limited competition on the ratings market and the limited transparency of ratings activities. Nonetheless, fear of damage to reputation and loss of income is necessary for the development and preservation of the quality of the credit ratings.

Civil liability

The conclusion from the preceding two paragraphs about control options is that increasing competition and the possibility of damage to reputation will not always offer sufficient incentive to the CRAs to make the interests of issuers and investors a central focus of their activities. Holding out the possibility of civil liability may offer CRAs additional (and probably stronger) incentives to make every effort to prepare good ratings. Anyone acting contrary to the law of civil liability can be held liable for payment of compensation. This prospect has noticeable preventive effects (Landes and Posner, 1987, pp. 4–5, 45 *et seq.*; Shavell, 1987, p. 5 *et seq.*; Polinsky, 1989, pp. 39–52). The threat of liability and the related liability for compensation influences the conduct of parties potentially responsible for loss or damage. They have (greater) incentive *ex ante* to act with due care and to avoid others suffering any loss or damage. The actions of CRAs when preparing credit ratings may possibly have negative external effects (harmful consequences) for investors and/or issuers. It has been found above that because of the existence of information asymmetry, and the related benefits in the short term, CRAs are not always optimally incentivised in their ratings activities. Civil liability and the requirement to compensate any loss or damage caused constitute expenses for any CRA (cf. Weterings, 2007, pp. 224–225). The external effects become internalised as a result (Carney, 1999, p. 665). In other words, CRAs then have greater incentive to take the possible negative consequences for investors, issuers or others into account when undertaking their ratings activities (Weterings, 2007, p. 24). Any CRA failing to do so will be required to compensate any resulting loss or damage. This prospect will have a (preventive) corrective effect on CRAs.

LIABILITY OF CRAS; PRINCIPLES

The civil liability of CRAs vis-à-vis issuers and investors might in the Netherlands be on the

basis of an attributable shortcoming (breach of contract) or a wrongful act (negligence). In this regard, the comparison with the liability of accountants and civil-law notaries, who are similarly required not only to guard the interests of their contractual counterparty, but also to guard the interests of third parties, presents itself.

In all, or at any rate most, countries and legal systems any liability on the part of CRAs rests (will rest) on a contractual basis or on the basis of tort law. This is also the case in the United States and England, where most liability claims against CRAs will occur. The criteria, and the specific details and evaluation thereof, are (largely) comparable in this regard (cf. Stolker, 1995, p. 15 *et seq.*; Van Dam, 2006, pp. 102, 141, 235, 298 and 342). Seen the similarities with regard to the basics of contract law and tort law, the different countries can learn from each other, at any rate. Furthermore, similar basics and criteria will, to a certain extent, sometimes be differently interpreted and used in different systems or countries. Therefore, it might be interesting to learn how claims against CRAs will be handled (or at least should be handled in our opinion) in the Netherlands. Different interpretation of similar principles could lead to a deeper knowledge of the own legal system and opportunities to perfect the own legal system.

Below we will run through these principles of (Dutch) contract law and tort law briefly.

Breach of contract

In the case of a *solicited* rating, the basis of the relationship between the CRA and the issuer is a contract for the provision of professional services (article 7:400 Dutch Civil Code) between these parties (Bertrams, 1998, p. 357; De Savornin Lohman and Van't Westeinde, 2006, p. 223). The contractor (CRA) undertakes vis-à-vis the principal (issuer) to provide a service. The assignment awarded by the issuer to the CRA is to prepare a credit rating. The above is also applicable in the event that an investor has requested the CRA to produce

a rating. If a CRA fails attributable in the performance of its contractual obligation (is in breach of contract), then it is obliged in principle to compensate any loss or damage suffered by the issuer as a consequence (article 6:74 Dutch Civil Code).

To answer the question whether a CRA has failed attributable in the preparation of a credit rating, is the relevant item in Dutch Law. A contractor must observe the care due by a good contractor when performing his work (article 7:401 Dutch Civil Code). In many countries, courts apply the criterion of 'the reasonable professional' (Stolker, 1995, p. 16; Van Dam, 2000, pp. 268–271; Van Dam, 2006, pp. 220–225).

It is not sufficient for a professional service provider to provide quality that is of below average level. The circumstances of the case determine what the term 'reasonable professional' constitutes in that specific case. The nature and content of the contract play an important role in this regard (Van Zeven and Van der Heijden, 1998, p. 335). The same applies to the characteristics of the parties. The degree of expertise, or professional competence, in particular is relevant in this regard. This means that a considerably high degree of care may be expected of a CRA. The greater the expertise or professional competence of the contractor, the greater the demands that may be placed on the quality of his performance. A CRA is pre-eminently professionally competent with regard to producing credit ratings, whereas the issuer has no professional competence in this regard and at the same time has a major interest in a good quality rating.

Negligence

If an investor (in the case of a *solicited* rating) or a company with an *unsolicited* rating suffers loss or damage because of a 'faulty' credit rating, it cannot fall back on a contract with the CRA. As there is no contractual relationship, there will have to be evidence of an attributable wrongful act (negligence; article 6:162 Dutch Civil Code) if a CRA is to be liable vis-à-vis an

investor or issuer. For this to be the case, there must generally be evidence that the CRA has acted contrary to a standard of due care. This is in effect the same standard as in the case of the contractual basis. When assessing the *duty of care*, the knowledge and expertise of a reasonably competent service provider acting reasonably is taken as a reference or benchmark (Van Dam, 2000, pp. 268–270; Van Dam, 2006, pp. 223–224).

Here, too, the greater the expertise or professional competence of the service provider, the greater the demands that may be placed on the quality of his performance. As regards the criterion of required due care that must be applied in relation to the service provider's actions, it therefore often does not matter whether a claim is based on breach of contract or wrongful act. A CRA is nonetheless more likely to be liable vis-à-vis its principal (issuer in the case of a solicited rating; investor in the case of an unsolicited rating) than vis-à-vis any third party, such as investors, with whom it has no contractual relationship. This is because there is a greater distance between a third party and the rating activities of a CRA. This will often imply that a CRA is more likely to have acted negligently vis-à-vis a principal than vis-à-vis a third party. It is debatable whether the CRA should have paid attention to the interests of the third party in respect of the rating activities, and should have tailored its actions accordingly (article 6:163 Dutch Civil Code). This is, incidentally, likely to be the case with foreseeable loss or damage and/or apparent interests of third parties (such as investors in the case of rating activities carried out by a CRA).³ This is (in the Netherlands) also the case with accountants in relation to reasonably foreseeable third parties using their information.

CRAS' DISCRETION

When considering the liability of CRAs and the specifics of the standard of due care resting on them, it is also necessary to bear in mind that a credit rating, in addition to implying

an objective, factual evaluation, also implies a subjective evaluation by the CRA. A rating is not an assurance or absolute fact, but rather a reasoned expectation for the future. Bertrams argues correctly that preparing a credit rating is not a rigid, mechanical process in which clear-cut criteria with a fixed specific gravity, ratios, models and statistics are entered and from which a certain rating then follows (Bertrams, 1998, pp. 355–356). CRAs must therefore be granted a certain amount of discretion. That it is in the nature of credit ratings that they express the opinion of their producers, has a mitigating effect on the liability of CRAs (Bertrams, 1998, p. 356). CRAs are therefore less likely to be deemed to have acted negligently. The fact that the CRA's expectation for the future eventually fails to materialise does not automatically mean that the credit rating is faulty and that the CRA has acted negligently, since a multiplicity of uncertain factors influences the issuer's creditworthiness and these are not (always and/or to their fullest extent) foreseeable, even by a professional party such as a CRA. On the other hand, one is entitled to expect a reasonable degree of reliability from a credit rating (Bertrams, 1998, p. 356). The limit of the CRA's discretion is exceeded when, viewed from the perspective of the reference person ('the reasonably competent professional acting reasonably'), the CRA, viewed objectively, should not reasonably have been able to arrive at the rating in question. The CRA can only be reproached if it fails relative to the *reasonably* competent professional acting *reasonably in identical circumstances*. The CRA's discretion referred to above also plays a role in this regard. This means that, within a certain band (in view of the term reasonableness), a CRA has the possibility of choosing between a range of options, all of which are capable of standing up to the objective test of the reasonable reference person. Liability only becomes an option if the CRA acts outside this band.⁴ Courts (and any experts engaged by the courts) will therefore apply restraint when assessing this matter. It is not important whether in

retrospect a different evaluation would have been better, but whether the CRA could have reasonably arrived at the rating in question.

This failure relative to the reference person becomes relevant in any event if it is established that the CRA has culpably produced an evidently incorrect credit rating, which differs markedly from the rating that should have been arrived at. In our opinion, a CRA must therefore be assumed to be liable if it has used inaccurate facts and it was aware, or should have been aware, of this inaccuracy. One could also conclude in favour of liability if the CRA did not observe the required objectivity and neutrality when preparing the rating (Bertrams, 1998, p. 357). In addition, liability on the part of a CRA can be assumed if it is clear that the CRA has acted without sufficient professionalism and due care when producing the rating.

In our opinion, too many claims against CRAs have so far been dissuaded in the United States by invoking the freedom of expression. Although it is true that a rating has an element expressing the opinion of the producer, it nonetheless also comprises an objective, factual evaluation of the available information. This denotes a limitation of the CRA's discretion. In certain cases there may indeed be reason to assume liability. From the perspective of the incentive effect of civil liability, this must be possible. 'Immunity' against liability for CRAs should be rejected.

CRAS' OBLIGATION TO INVESTIGATE WITH RESPECT TO INFORMATION OBTAINED

In most cases, therefore, incorrect use of information may give rise to potential liability on the part of a CRA. This is not surprising given the information asymmetry described above and the possible problems that may ensue from it. As an expert in the field of credit ratings, a CRA may be expected not to issue a credit rating until it may be assumed with a reasonable degree of certainty that the information at its disposal is accurate and that it also has

access to all, or at any rate sufficient, relevant information needed to be able to produce a good rating.⁵ A CRA is to a certain extent dependent on other parties for the information provided to it and is not empowered to be supplied with all information, so that courts will apply restraint in their assessment in this regard. On the other hand, in our opinion this does not release CRAs from the obligation to subject the information provided to them to further examination. Indeed, given the influence of information on the determination of the rating and the consequences eventually attached to a rating in financial dealings, a CRA may be expected to do precisely that.

The CRAs are of the opinion, however, that they are merely 'intermediaries' or 'conduits' of information.⁶ They should not, therefore, be held responsible for the accuracy and completeness of the information (Bakkerus, 2000, p. 65). Certain critical remarks should be made in this regard. First, CRAs should not rely on the accuracy and completeness of information if that information is not consistent with other facts known to them.⁷ In addition, a CRA may not issue a credit rating if it ought to be aware of the inaccuracy and/or incompleteness of the information (Bakkerus, 2000, p. 64). Second, CRAs are more than a mere conduit. According to CRAs, credit ratings are independent evaluations with respect to the creditworthiness (of the securities) of a company (Coskun, 2008, pp. 612–613). This stated independence of their evaluations is not consistent with the idea that CRAs merely pass on information. The information from and about a company has a significant impact on the eventual credit rating. This fact therefore implies precisely that a CRA is obliged to subject the information supplied to it to thorough and careful evaluation and verification. Given the professional competence, stated independence and (considerable) compensation of CRAs, as well as the apparent interests of issuers and investors, it may be expected that the process of drawing up a credit rating satisfies certain quality requirements and that information has been carefully

checked, evaluated and weighed. It is also not unreasonable to demand such thoroughness of CRAs and to impose an obligation to investigate on them (Huijgen, 1999, note 8). They also have the possibilities to carry out a further evaluation/verification of the information submitted by the issuer and, where necessary, to 'enforce' this in respect of the issuer. Market players such as 'large' (institutional) investors partly base their actions on credit ratings. This gives the issuer a direct interest in taking the wishes of a CRA seriously (Boot, 2006, p. 4). CRAs can therefore require the issuer to allow them to carry out additional research *ex ante* (before or on entering into the contract) in order to enhance the quality of their credit ratings. *Ex post*, CRAs may set in motion a 'credit watch procedure'.⁸ If the CRA fails to use these possibilities then we believe that this has consequences for its liability.

Independence and objectivity

Independence and objectivity are of great importance with regard to the quality of credit ratings. In principle, a higher degree of dependency leads to (a greater likelihood of) reduced objectivity. The current fee model ensures the CRA's dependence on the issuer in the case of a solicited rating. A CRA's duty to investigate is therefore greater than if no such relationship of dependency exists/were to exist. The CRA's obligation to carry out a further *ex-ante* or *ex-post* investigation into the issuer's financial position will also be considered more likely to exist. Therefore, a CRA's obligation to investigate is construed as meaning that a CRA should ensure that it has sufficient and accurate information at its disposal to enable it to carry out high-quality credit assessments (article 1.7 IOSCO Code). The standard of due care also implies that a credit rating is based on a thorough analysis/examination of all information known to the CRA at that time (article 1.1 IOSCO Code). All information known to the CRA must – in so far as it is relevant to the creditworthiness of the issuer or the issue – be incorporated into the credit rating. In this

regard, such information must be incorporated in a professionally competent manner into the rating and the information available must, with due regard for the CRA's discretion, be capable of supporting the rating that is awarded. In view of the information asymmetry referred to above, it is desirable that liability law should provide incentives to deal with information in this way.

In addition, greater transparency and internal quality criteria can increase the quality of the rating activities, the independence of CRAs and trust in CRAs. This is also extremely important within the accountancy profession. It also impacts on the possibility of liability. Accounting bodies, for example, often set standards for the work carried out by the accountants who are members of them and they promote the quality of and compliance with laws and regulations. These professional standards and the supervision of compliance with them ensure a better quality of services, as well as greater objectivity and transparency. Greater attention to quality will in itself lead to fewer claims.

This also has an impact on the likelihood that claims will succeed. Compliance with professional standards does not in itself exclude the possibility that a duty of care may nonetheless have been infringed, resulting in civil liability. Nevertheless, it is (far) less likely that circumstances will exist which (may) result in liability. A court will often use these guidelines of one's own profession when interpreting and assessing the standard of due care. Conversely, infringement of one's own professional standards will not automatically imply a failure or breach under civil law. However, non-compliance with these standards will likely give rise to the assumption of a factual presumption that the professional has not acted in the manner of a professional practitioner acting normally and with due care.

CONCLUSION

Financial scandals such as the Enron affair in the United States and the present financial crisis give us grounds to reflect critically on the role

of CRAs when awarding credit ratings. It is an established fact that CRAs have not functioned properly in a number of cases. This would seem to be directly related to structural imperfections in the financial markets. These have their origin in the aforementioned information asymmetry between the CRAs and the issuers, on the one hand, and between the CRAs and the investors, on the other hand. In this article this information asymmetry is characterized as the dual asymmetry problem. CRAs are not given enough incentives always to do their work – producing high-quality credit ratings – well. As a result, issuers and investors may possibly, under certain circumstances, suffer considerable loss or damage in the short or long term.

Once it is understood that all three market players involved – the issuer, the CRA and the investors – always act under uncertain relationships, then the surprise about the notoriously weak performances of the CRAs that occurred in a number of cases may not be unreservedly qualified as deserving reproach. However, a completely honest assessment would require an objective analysis, which is not available. From a theoretical perspective also there is no complete evaluation model with regard to CRAs, also integrating the phenomenon of information asymmetry, available.

Boot (2008) refers to CRAs as a 'mixed blessing'. Conflict of interests and fee structure have proved to be major shortcomings in practice. There is a significant absence of meaningful competition between the three leading CRAs. Rather, an oligopoly exists. Unsolicited ratings, for which CRAs receive no payment, may be linked to abuse of market power. CRAs will inevitably have to operate strictly independently and with integrity, as assumed in the models, if they wish to have a future in which they are appreciated by society. Among other things, the emergence of new financial products such as CDOs has considerably increased the risk of a conflict of interests (cf. Boot, 2006; Beetsma, 2008). Beetsma even goes so far as to call for a public body to be established that would be responsible for producing ratings,

thereby causing the disappearance of the private agencies as a matter of course. We believe that this goes too far, as it might lead to the creation of a different type of conflict of interests, namely with political bodies. The question is whether the emergence of the credit default swap market (CDS market), where creditworthiness can be insured by the combined market players in supply and demand, has consequences or should have consequences for the continued existence of CRAs (Gibson, 2007). If this relatively new market is able to evaluate creditworthiness more quickly and reliably, then the dependency of market players on the CRAs can no longer be taken for granted. Their role would then appear to be over. The daily listed price for the premium for such an insurance is certainly more informative than an inevitably delayed change in a rating to be issued by an agency of possibly limited integrity, as shown during the recent crisis involving Greece. The CDS market is a public market in which every interested party has quick access to information about the quality of the creditworthiness of debtors. A distinct advantage of this market is the fact that rather than a dozen individual employees of a rating agency, it is the combined grouping of insurance offerors and clients that decides what is a fair premium: that is, a real market.

The introduction of effective civil liability will, unlike the incentives of competition and reputation, certainly have the required corrective effect on the way in which the CRAs operate. Empirical research shows that increased competition has an adverse effect on the quality of credit ratings. As the Enron affair and the current credit crisis have shown, reputation alone has not prevented the CRAs from listening to their own financial interests very intensively. Civil liability, which, as previously stated, may be expected to have a beneficial and preventive effect, must offer a remedy.

It would lead to CRAs being held liable by issuers and investors for the loss and damage they have suffered in many countries, including the United States. Breach of contract constitutes

the legal basis for issuers with a *solicited* rating. Investors and issuers with an *unsolicited* rating will have to define and substantiate liability for their loss or damage via the doctrine of wrongful act (negligence). It should be noted that irrespective of the basis of liability, CRAs must be allowed a certain degree of discretion in producing their credit ratings. The standard of due care that applies to CRAs as described in this article is intended to enable a further definition of what constitutes culpable behaviour on the part of CRAs. This will be specified and made concrete by reference to the factors objectivity, independence, professional competence and due care. These factors should be considered and weighed individually, as well as in their mutual interrelationship. Depending on the circumstances, CRAs may possibly have a farther-reaching obligation to investigate.

NOTES

- 1 Heineken issued a bond loan without credit ratings from S&P's, Moody's and Fitch. Provided that investors are compensated for the absence of a credit rating, a company also has access to the financial market. See www.fd.nl/artikel/11293610/update-heineken-prijst-obligatie-eur1-mrd-swaps-4-50.
- 2 Many (experienced) analysts employed by the CRAs have moved to a company whose financial products they previously assessed.
- 3 Cf. HR 27 November 2009, RvdW 2009, 1403 (Worldonline) and HR 13 October 2006, NJ 2008, 528 (Vie d'Or).
- 4 Cf. the submission of AG Rank-Berenschot before the Dutch Supreme Court 8 May 2009, LJN: BH1191, 08/01359.
- 5 Cf. HR 10 December 1993, NJ 1994, 667 (Van Ittersum/Rabobank), HR 4 February 1977, NJ 1978, 278 (HR Gerritsen/de Zwaan). An analogy can also be made with the considerations in HR 27 November 2009, RvdW 2009, 1403 (Worldonline).
- 6 The statement made by Ronald Barone, board member of S&P's, is illustrative; he said that: 'Standard & Poor's relies on the

issuer and its counsel, accountants, and other experts for the accuracy and completeness of the information submitted in connection with the rating process'. Testimony of Barone (2002).

7 Cf. HR 2 December 1994, NJ 1995, 246 (HR ABN Amro Bank/Coopag).

8 If, because of a change in business conditions, the credit rating is possibly no longer up-to-date, the CRA will carry out a further review in this regard. This often results in an upward adjustment ('upgrade') or downward adjustment ('downgrade'). This review is called the credit watch procedure. S&P's refers to a 'CreditWatch', Moody's a 'Watchlist' and Fitch a 'RatingAlert'.

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