

The Critical Review Towards the Article of Professor Miglionico on the Disclosure Regime of Credit Rating Agencies

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Abstract: Generally, those Credit Rating Agencies are regarded as commercial institutions that provide professional suggestions on the possibility of the issuer repaying its debts in full and on time. For investors, it could be utilized to ensure the transparency of credit quality and quarterly disclose relevant information, in order to provide assistance to investors to familiarize themselves with relevant financial markets. Although credit rating is not a guarantee or absolute indicator, it is, to a large extent, an essential tool in the process of critical decision-making. It is commendable that the author Miglionico has effectively analysed the role and limitations of CRA system which makes it deserves to be studied.

Keywords: Credit Rating Agency, Investors, Issuers, Legal Regulations.

1. Introduction

With the continuous development of economic globalization, the Credit Rating Agency emerges as the times require. However, as far as the practical application of the CRA is concerned, it not only brings opportunities and convenience for investors and financial companies but also increases dealing risks objectively, which bruised the confidence of the investor to some degree and affect the development of the stock markets.

The author Miglionico in his article "The disclosure regime of credit rating agencies: an obscure veil of compliance?" illustrates the main point that the information disclosure capability of the CRA has failed to meet reasonable expectations of the public. Specifically, agencies of credit rating are selected by financial companies that issue debts and then depend on the remuneration paid by those companies, which leads to potential conflicts of interest between bond issuers and investors, because those agencies of credit rating have a natural preference and dependence on bond issuers. Hence, for credit rating behaviours, it is essential to improve the quality of information disclosed to investors, so as to ensure the realization of their and interests.

The reviewer believes that although there are a few research blind spots in this article, it still has indispensable value in the field of the CRA, aiming to analyse the role and limitations of the CRA system in detail and attempts to put forward some legal regulation measures.

2. Summary

This article presents purely theoretical arguments in its main research area of the means of the information disclosure and legal regulations of the CRA. It is clear that the author Miglionico divides the whole article into five parts. In the first part, the author examines the business model of CRA. In the second part, the author summarizes the role of CRA and the applicable regulatory system. In the third part, the main problems affecting the reliability of credit and non-credit rating are analyzed. In the fourth part, potential risks

regarding CRAs' information systems and misclassification are enumerated. In the last part, the author discusses the issue of conflict of interest and critically evaluates the limitations of the compliance function of the CRA, in terms of review and monitoring methods. However, in fact, the reviewer believes that the core research content of this paper can be concisely divided into two key points, and the author writes less about the latter which seems to make the structure of the article a little unbalanced.

On the one hand, the author Miglionico focuses on the current situation of unsatisfactory legal regulations and relevant root causes. The author emphasizes that the information disclosure capability of the CRA depends on its reliability and public acceptability. Whereas, it is questionable that whether the CRA could maintain the accuracy and stability of messages provided to financial markets, as there are no internal written policies and procedures that address the opacity of the CRA. The rating method will evolve over time and might be constantly adjusted in accordance with novel messages and economic development. Furthermore, these adjustments are often not obvious, and the CRA usually carefully controls the number of rating changes caused by these adjustments to a minimum. The author lists three well-known laws or regulations as argumentations. Firstly, the "basic code of conduct for the CRA" formulated by the international organization of Securities Regulatory Commission (IOSCO) is not only the basic code for the international credit rating industry but also the world standard for the self-discipline of credit rating agencies. However, it often failed to protect investors and maintain the fairness, efficiency and transparency of the market in practice. Secondly, the Basel III is merely an improved version of the Basel II without any revolutionary achievements because although higher capital requirements might inhibit banks from engaging in high-risk businesses closely related to the financial crisis, this method may also hinder them from making profits. Finally, the CRA regulations 2013 introduces the civil liability system which means that rating agencies must comply with more strict rules, or they could be forced to take responsibility for negligence

or intentional wrongdoings. However, some provisions on corporate governance in this regulation increase the cost of rating agencies in network system construction, staff training and legal consultation, which is not conducive to the development of small and medium-sized credit rating agencies. In terms of the above phenomena and problems, the most fundamental factor that needs focusing on is the business model of "issuer pays". The author Miglionico also lists two main argumentations. One is *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (In Liquidation)* and the other one is about the rating failure and scandal of wealth among Enron, WorldCom and Lehman Brothers.

On the other hand, the author Miglionico has found some effective content of legal regulations that can be utilized and further developed. Some obvious argumentations are as following. The new Dodd-Frank act of the United States repeals most of the Dodd-Frank act, aiming to relax the conditions of financial supervision and reduce the rights of financial regulators to a certain extent, especially the revocation of the Volcker rule. Article 6 of the regulations on credit rating agencies in 2013 stipulates specific restrictions on shareholders or members of credit rating agencies. The EU's credit rating regulatory framework, which is mainly based on ESMA and supplemented by the competent authorities of other Member States, has also played a great role in the European market.

3. Evaluation

(1) The author Miglionico has successfully analysed the causes of the credit crisis of credit rating agencies, which is very comprehensive and persuasive.

The conflict of interest caused by the charging mode is the primary reason. With the reform of the CRA in the USA, the rating methods of credit rating agencies around the world have gradually changed from unsolicited rating to solicited rating. In the meantime, the charging mode has changed to charging the rated agencies. However, this kind of charging mode causes internal conflicts of interest among credit rating agencies. Issuers all desire to get higher ratings, so as to reduce the issue cost and obtain more benefits. Therefore, they might entrust several rating agencies to rate them in the meantime, and then choose the rating that is most beneficial to them to be disclosed to the market. Moreover, in order to attract customers' attention as much as possible, the rating of credit rating agencies is sometimes adversely affected by other rating agencies and customers' needs.

The decline of competition vigour caused by the monopoly is the second factor. The international credit rating industry is basically monopolized by Enron, WorldCom and Lehman Brothers. Due to the monopoly and authority of historical reasons, they occupy the vast majority of the market share in the CRA area. The world market follows the national recognition system created by the USA, which further consolidated its monopoly position. The new credit rating agencies are always in a weak position in the market competition because of the lack of experience and the impact of the capital chain.

The drawback of existing risk models is the third factor. Credit rating agencies often do not downgrade scores that they made for institutions until they occur or worsen of the crisis so that they not only fail to play a warning role but also aggravates the market turmoil, which is condemned by the

majority of investors. Moreover, the rating model of credit rating agencies is open to investment banks, and investment banks are responsible for the issuance of securities so that issuers tend to pursue the requirements of rating one-sidedly, rather than those of regulatory rules.

(2) The author Miglionico has realized that further stipulation and improvement of the relevant legal system are need and has listed some existing and effective legal provisions in order to readjust information disclosure activities of credit rating agencies. The reviewer believes that the general analysis of the author is quite good and it might be better if the author could summarize the aspects that legislators should pay more attention to in the future.

Firstly, the existing charging mode should be changed. If issuers are no longer the main source of income for credit rating agencies, they might not ignore professional standards in order to obtain benefits. Meanwhile, the benign competition among credit rating agencies may lead them to make timely and accurate information disclosure in order to draw more public attention. Secondly, the transparency of information disclosure of credit rating agencies should be enhanced in a further step. More authoritative public or private rating agencies should be established through legal channels and regulators and investors should obtain information of investment risks in a more diversified way, which could provide an effective basis for setting the scope of risks undertaken by financial institutions, and play a role of financial supervision and risk warning for the market. Finally, the scope of credit rating agencies should be further restricted. In order to reduce the impact of credit rating agencies on other industries, the scope of rating can be limited to a certain extent in the legislation. For example, in the case of bonds issued by sovereign countries and bonds related to national defence, credit rating agencies have no authority to rate.

(3) The reviewer believes that the praise of the author Miglionico to disclosure doctrine is excessive because the limitations of disclosure doctrine are obvious as well.

First of all, the content that can be disclosed could only be limited. The core competitiveness of rating agencies lies in their technical secrets. If this information about the quality of rating results is disclosed, the rating results will no longer be meaningful. It is neither possible nor necessary for the legal provisions to require rating agencies to disclose all information without reservation. Then, the understanding ability of investors is limited. Investors neither need nor have abilities to understand every piece of information disclosed by rating agencies. Finally, the role of disclosure doctrine is also limited. Conflict of interest, market monopoly and the trust of investors are still the internal or external factors that interfere with the realization of disclosure doctrine. In the short term, the methods and procedures of credit rating might hardly be substantially improved.

4. Conclusion

Overall, the author Miglionico in his article "The disclosure regime of credit rating agencies: an obscure veil of compliance?" makes a comprehensive analysis about the current situation of the CRA with external and internal causes and relevant legal regulations. There is no doubt that the reliability of the Credit Rating Agencies has been questioned after the inaccurate risk assessment for financial products such as mortgage loans, and the impact on the stability of the

securities market. In order to protect the interests of investors from the legal level, the accuracy, completeness and righteousness of the CRA in disclosing information and evaluating the reputation of corporations should be enhanced. Furthermore, some individual investors are inexperienced and incompetent so that even if they get all accurate information, they might also make incorrect decisions about the risk. The author Miglionico should continue to expand the research in this area.

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