The Credit Risk Assessment and Its Contribution to the Global Financial Crisis

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Contents

Introduction

The Global Financial Crisis triggered in 2007 has its negative impact on the whole global economy. Many financial institutions have gone bankrupt. Many employees lost their jobs as a consequence therefore. Additionally, investors in the financial markets lost their money.

Indeed, the reasons for the financial crisis are multitude. However, it is submitted that the main reason that underpins the Crisis is the incorrect assessment of the risks associated with the financial instruments. As will be seen in the following chapters, such inappropriate assessments are partially because of the complexity of the current financial products and partially because of the dramatic fall in the house prices.

Although, the focus will be on the due diligence process and the credit rating process as they are the main elements of the credit risk assessment, reference will be made to the process of securitisation so as t be able to realise the context in which the said elements operate. The main emphasis of this paper will not be limited to the role of the due diligence process and the credit ratings in the Global Financial Crisis, rather it will be extended to examine how regulators restructured the rules related to these elements as a response to the Crisis.

Accordingly, this dissertation will be divided into three chapters. The first chapter will be devoted to explain the basic components which, if combined, constitute the Global Financial Crisis. This will encompass an analytical comparison between corporate bonds and securitisation, a comparison which will be used later to acknowledge the role of the elements of the credit risk assessment in the financial crisis. The said comparison will also be useful to realise the complexity of the securitisation transactions. This chapter will also define the due diligence process and credit rating and how they can effectively assess the credit risks and who is responsible for conducting each of them.

One the other hand, the second chapter will address how the inappropriate credit risk assessment, represented in these elements, contributed to the Global Financial Crisis.

However, a brief history about the Crisis will be given in the beginning in order to link between this elements and the Crisis.

The third chapter will be dedicated to the initiatives taken by the regulators, especially in the EU and the US, to reconstruct the rules related to the due diligence process and the credit rating agencies in order to avoid further crisis. Also suggested reforms by scholars will be briefly mentioned.

Chapter one:

Basic concepts and terminologies

Introduction

In this chapter the two main aspects of the checking process, namely, the rating review and due diligence, that precede any bond issuance will be fully explained to the extent required to understand their role in the Financial Crisis.

The analytical comparison between corporate or traditional bonds and bonds issued through the process of securitisation:

At the outset, it is essential to draw a clear distinction between corporate bonds and bonds issued through the securitisation process, so as to be able to understand the context in which the said elements of the credit assessment will operate. Bearing in mind that the later type will be our main concern as it is the main reason for triggering the financial crisis. Such distinction will be of relevance importance when discussing the role of the credit rating agencies on the financial crisis in chapter two.

- **Corporate bonds:**

Under this category, bonds are defined as "means of borrowing money by issuing the lender with a transferable security in return for the loan, as well as undertaking to pay interest on the loan and to repay the loan capital at the end of the loan term".[1] Bonds falling under the category concerned are to be arranged by investment banks (managers or underwriters). The managers, against a fee, will be responsible to procure subscribers for the security as stipulated upon in the subscription agreement.[2]

In this context, reference must be made to the offering circular or prospectus. The prospectus can be seen as a necessary tool to attract more investors since it is a prerequisite for offering securities to the public, hence, enlarging the number of participants. Usually, it is conducted by the issuer in conjunction with the managers. Preparing the prospectus is the stage in where the due diligence plays a predominant role.

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[1] Hudson, *The Law of Finance*, (1st edn Thomson Reuters, London 2009) 910
[2] Philip Wood, Law *and Practice of International Finance*, (University Edn Sweet & Maxwell, London 2008) 159

- **<u>Bonds issued through securitisation:</u>**

Securitisation or asset-backed finance is a process that creates "a series of bonds or notes supported by the income streams generated by a pool of underlying assets ... The effect of securitisation is to convert a pool of underlying loan based assets with possibly unpredictable income streams and repayment schedules into a single class of securities (although possibly with more than one tranche) with confirmed and predetermined interest and maturity terms".[3] Actually, securitisation can be seen as one of the most important financial innovations.

The typical transaction will involve three parties, i.e. the originator, the Special Purpose Vehicle (SPV) and the investors.[4] As illustrated in figure 1, the originator will sell the underlying assets or receivables to the SPV which will finance the purchase price via issuing bonds, secured on the said receivables, to the investors.[5]

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[3] G A Walker, *Asset-backed Finance and Securitisation* (Web CT, Queen Mary – University of London) 4

[4] SPV refers to "a company that is created solely for a particular financial transaction or series of transactions. It may sometimes be something other than a company, such as a trust" http://moneyterms.co.uk/spvspe accessed 15 June 2010

[5] Philip Wood, Law *and Practice of International Finance*, (University Edn Sweet & Maxwell, London 2008) 425

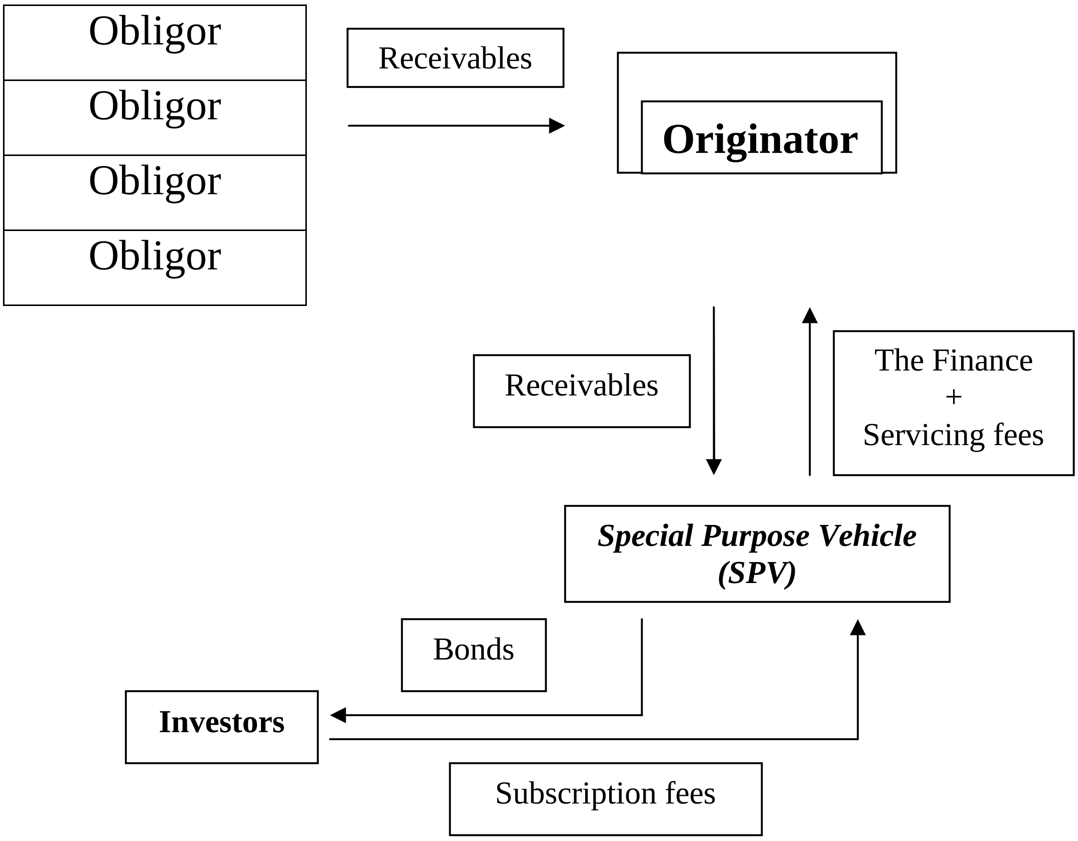

Figure 1: The process of Securitisation

For the transaction to be successful, two conditions shall be fulfilled. First, the sale of assets to the SPV must be a true sale in order to qualify as an off-balance sheet transaction.[6] Second, The SPV shall be newly established and completely independent from the originator by being held by a charitable trustee or any other independent third party rather than being a subsidiary of or held by the originator.[7] These two conditions will isolate the investors from the insolvency of the originator.

In practice the bonds or notes issued by the SPV will be divided to senior and junior notes. The first loss will be deducted from the junior notes. Hence, the junior bonds are more risky and, accordingly, carry higher interest rate. As for the senior bonds, they are usually rated AAA. The technical jargon for this process is tranching.[8]

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[6] R. Parsons, P. Taylor and A. Rovira, "*Asset securitisation and the effect of insolvency on special purpose vehicles*" (Sidley Austin Brown & Wood LLP, European Structuring) < http://www.europeanrestructuring.com/05intro/036_041.htm> accessed 3 July 2010

[7] Philip Wood, *Project Finance, securitisations, Subordinated Debts* (Volume 5 Sweet & Maxwell, London 2007) 6-001

[8] n5 453

In the securitisation process, the nature of the receivables will determine the exact name of the transaction. If the receivables are bank loans then the transaction will be described as “collateralized loan obligations” (CLOs). Receivables consisting of loans secured by mortgages of commercial property will be referred to as “Commercial mortgage-backed securities” (CMBS). However, as the main topic regards the Global Financial crisis, emphasis will be limited to the “collateralized debt obligations” (CDOs) in which the receivables are a mix of loans and bonds and “residential mortgage-backed securities” (RMBS) in which the receivables are loans secured by mortgages of residential property.[9]

- **<u>Concluding remarks:</u>**

After the explanation of each transaction separately, it is now clear the difference between bonds created through securitisation and those discussed in the previous section is that the former are secured by a pool of receivables, whilst the latter are secured by the issuer’s own assets or even are unsecured.[10] An additional key difference is represented in the fact the relationship between the issuer and the investors in corporate bonds are more straightforward than its counterpart in the securitisation adding more complexity to the later. Having said that, the models and the methods that should be used to assess risks cannot be the same in both types, since the second type requires more sophisticated models to assess the risks associated therewith.

1- <u>The two-fold element of credit risk assessment:</u>

- **<u>The due diligence</u>**

1- <u>Understanding due diligence:</u>

  - <u>Definition:</u>

The definition of the term due diligence can be easily concluded from the name itself. Linguistically speaking, the word due simply means proper and correctly

[9] n7
[10] Marke Raines, *“UK Securitisation”* Banker’s Law Volume 1 Number 2 page 1

conducted.[11] Diligence involves care, attention and application.[12] As an adjective-noun compound, due diligence refers mainly to carrying out of one's duty as efficiently as is necessary.

In a legal context, the concept of due diligence is utilized to describe the process of investigating and assessing the financial and legal status of a certain company so as to enable the lenders and/or buyers of the said company to identify the potential risks associated with their transactions and to establish a fair value for the transaction. Generally speaking, due diligence is to be performed in any securities offerings and acquisitions. In respect of issuing bonds, due diligence will be exercised with respect to the preparation of the prospectus and its content.[13] It is approached by talented lawyers and financial experts.

- ROOTS:

The concept concerned has been originated in the US financial regulations. The due diligence has first been introduced by US Securities Act 1933 s 11(b) (3) as a defence to those who had exercised a reasonable care while producing the content of a prospectus required to issuing securities.[14] The concept then expanded to be used worldwide.

2- Functions of due diligence:

> *"Understanding an issue before completion is much better than having the ability to make a warranty claim after completion"*[15]

The main purpose of the due diligence in the context of bond issuance is to assure the underwriter that nothing will go wrong in relation to the underwritten bonds.

[11] P.H. Collin, *Dictionary of Law* (3rd edn Peter Collin Publishing, Cambridge 2000)
[12] Linda S Spedding, *Due Diligence and Corporate Governance* (LexisNexis, London 2004) 2
[13] Andrew Mcknight, The Law of International Finance (Oxford University Press, Oxford 2008) 10.6.2
[14] n11
[1515] David Boyd and William Sharp, '*Trends in Legal Due Diligence in Acquisition Finance*' (2007) 11 JIBFL 658

Usually, the underwriter is always concerned about its reputation and relationships already maintained with its clients who are willing to purchase these bonds. [16]

Additionally, conducting a due diligence is a mean by which the underwriters can use to be exempted from any liability under the securities regulation of the country concerned. For example, in the US, the 1933 Act states that the underwriter(s) will be held liable if material facts were omitted from the registration statement and the investors suffered loss accordingly, such liability may be justified by the fact that banks and financial institutions have a better access to the issuers records than investors.[17] Consequently, the underwriter(s) will conduct the due diligence to assure that no such omission is taking place.

3- Scope and Elements of the due diligence:

The scope of the due diligence to be performed will vary according the type of the bond and the issuer thereof. The efforts to be embarked to conduct a due diligence on the issuer of the bonds in the securitisation will be less than these embarked on the usual process of a bond issue since the issuer of the bonds in the first category is the SPV that has no previous assets and liabilities or even employees, provided that the receivables that constitute the collateral have been truly purchased from the originator and the Arm's length principle has been fully applied, Whilst the issuer in the second category is company that needs the finance itself. The extent of the process will also be dependent on the cost and time constraints.[18] Moreover, securitisation, as will be discovered later in this chapter, entails transferring the risks to the second in the chain, leaving little or no incentives for any party therein to conduct its own due diligence.[19]

[16] USAID, '*Bond Issuance Tool Kit For Emerging Market Corporate Issuers*' Emerging Markets Group, Ltd (8 July 2005) [75]-[78]
[17] David Stowell, *An Introduction to Investment Banks, Hedge Funds & Private Equity* (Academic Press, London 2010) 24
[18] Michael G. Harvey and Robert F. Lusch, *'Expanding The Nature and Scope of Due Diligence'* (1995) JBV 6,7
[19] George Walker, *Financial Crisis Cause and Correction* (Financial Regulation International – Informa (2008))

Indeed, the documents that will be investigated during the due diligence process are multitude. The legal councils of the underwriters are obliged to insure that the issuer is duly incorporated and can validly issue securities. This can be accomplished by scrutinising the articles of incorporation and any other equivalent documents. Additionally, councils will review all documents in connection with and legal proceedings or judgements that may affect the prospective transaction together with any circumstances which will likely give rise to legal proceedings. Moreover, material contracts such as employment and insurance contracts will be included in the councils' check lest. Intellectual property rights which are created or transferred to the issuer's company constitute anther burden on the councils.

From a financial prospective, the process of the due diligence will assess the financial standing of the issuer. Such assessment will be established through evaluating the balance sheets, income statements and management financial reports of the issuer. Tax issues are carefully considered when conducting due diligence. The process shall be extended to include any other indebtedness, derivatives and off-balance sheet items. [20]

- **The credit rating:**

1- Understanding the credit rating:

- Definition:

Bond rating refers to the activity of assessing the possibility of default by the issuer and its ability to meet interest and principal requirements in a timely fashion.[21] In other words, it is a process by which the credit quality of a bond is to be identified. The credit rating is required in all types of bonds either corporate or governmental bonds.

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[20] Jeremy Harris, *Due diligence: Accounting Practice*, (Sweet & Maxwell, London 1999) Chapter 1

[21] David L. Scott, *Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor* (Houghton Mifflin Company, 2003)

> *"Ratings are a combination of "science" which is based on mathematical modelling of the entities' financial performance, and of "art", which is based on the analysts' assessment of prospects for the entity's business".*[22]

- History and background:

The starting point of the rating review was in 1869, a year in which a report titled "History of Rail Road and Canals in the United States" by Henry Varnum Poor, who then established his own company Standard & Poor's in 1916, published to assist in acknowledging investors with stock reporting and analysis. Thirty one years thereafter, Moody's Manual of Industrial and Miscellaneous Securities has been published by John Moody, a security analyst in Wall Street, who established his own company John Moody & company (Moody's) in 1900.[23] Fitch Ratings, the third dominant player in the ratings market, has come into existence in 1924 and is currently a part of the French Fimalak group.[24]

2- The credit rating: who is doing what?

In fact, the task of grading bonds is usually assigned to the rating agencies. Globally, the number of the Credit rating agencies exceeds one hundred. However, in the US ratings market, "Moody's Investors Service" and "Standard & Poor's Ratings Services" are dominant player in the ratings market with both retain 80 per cent of the market share, whilst "Fitch Ratings" has 15 per cent of the said marked.[25] The rating systems vary from agency to another and each of which has at least ten categories from AAA to C or D.[26] As will be seen in the later chapters the rating agencies played a significant role in the financial crisis which had been triggered in 2007.

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[22] Hudson, *The Law of Finance*, (1st edn Thomson Reuters, London 2009) 915
[23] Edmund Parker, *Regulation of Credit Rating Agencies in Europe* (2009) 7 JIBFL 401
[24] Deniz Coskun, *"Supervision of Credit Rating Agencies: the Role of Credit Rating Agencies in Finance Decisions"* [2009] JIBLR 2
[25] Angus Duff, *The Credit Ratings Agencies and Stakeholder Relations* (2009) 1 JIBFL 11
[26] Virginia B. Morris and Kenneth M. Morris, *Dictionary of Financial Terms* (Lightbulb Press, Inc, 2008)

As a matter of fact, most credit rating agencies are private and profit-seeking entities.[27] They provide their services in return for a fee paid by the issuer.[28] In US, credit rating agencies are supervised by the Securities and Exchange Commission (SEC).

The successful completion of the rating review entails the employment of qualitative and quantitative statistical models to predict the performance trajectory of the issuer.[29] The credit rating agencies will not only assess the probability of default by each obligor, rather they will assume correlated defaults of pool assets. The most recognized models for rating the CDOs are binomial expansion technique (BET) and Monte Carlo model.[30]

Thus, as it is essential for the upcoming analysis to draw a clear distinction between the process of due diligence and the rating review, credit rating agencies are not supposed to exercise due diligence nor an audit.[31] It is the originators' and ultimate investors' task to verify the information submitted by the borrowers. The data verified then will be streamed from the issuers and arrangers to the rating agencies with the later assuming that the due diligence has been conducted properly.[32]

3- Functions of credit rating:

Although they are vital to investors while making their investment decisions, ratings are neither recommendations to purchase nor comments on the suitability of an investment.[33] Rather, their main function is to evaluate the risks associated with

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[27] Timothy E. Lynch, *"Deeply and Persistently Conflicted: Credit Rating Agencies In the Current Regulatory Environment"* (Research Paper No 133, Indiana University Maurer School of Law-Bloomington 2009) 11

[28] Fabian Amtenbrink and Jakob de Haan, *"Regulating Credit Rating Agencies in the European Union: A Critical First Assessment of the European Commission Proposal"* (Fourth International Conference on Financial Regulation and Supervision, Bocconi University 2009)

[29] N23

[30] See more Ingo Fender and John Kiff, *"CDO rating methodology"* (BIS Working Papers No 163, Bank for International Settlements-Monetary and Economic Department 2004)

[31] Thomas Ross, *"The Role of Rating Agencies and Their Potential Exposure in the Ongoing Credit Crisis"* (2008) 7 JIBFL 349

[32] Michel G. Crouhy, Robert A. Jarrow and Stuart M. Turnbull, *"The Sub-prime Credit Crisis 07"* (2008)

[33] M. Fagan & T.Frankel, *MBS, ABS, SPV, CDS, ARM, BBB+: Understanding the Alphabet Soup*

different types of tranches; leaving the investor to choose from among these tranches according to the extent of the risk it is willing to take. Moreover, the importance of the credit rating lies in the fact that it ensures the marketability of securities which are newly issued.[34]

Consequently, the rating agencies are the key player in deciding the interest rates to be earned by each investor, since the interest rates mainly rely, together with the prevailing market rates, on the degree of the risk assessed thereby. Additionally, credit rating agencies play vital role in regulating the financial markets. Owing to the fact that regulators are not involved, at least before the Global Financial Crisis, in the CDOs market, Credit rating agencies are contributing in mimicking the likely existence of appropriate regulatory framework.[35] In other words, credit rating agencies can be considered as quasi-public regulators. Such function can be proved through mentioning the fact that even the Federal Reserve Banks utilized the ratings conducted by the credit rating agencies as a mean to assess the investment portfolios of several investment banks.[36] For instance, Rule 2a-7 of the US Investment Company Act 1940 states that "money market funds can only purchase commercial paper if it is of sufficiently high rating".[37] Another example is the provisions of Basel Committee for Banking Supervision which relate to the usage of ratings to ascertain the capital reserve requirement.[38]

With reference to the distinction made in the first part of this chapter between corporate bonds and securitisation, it is worth mentioning that in the structured finance, unlike corporate bonds, the credit rating agencies "run the show". In other words, credit rating agencies get involved in the CDOs from the commencement of the transaction. They advice the CDO originator on how to tailor the transaction so as

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of Securitization, Lecture slides, slide 20

[34] Tom Hurst, *"The Role of Credit Rating Agencies in the Current Worldwide Financial Crisis"* [2009] Company Lawyer

[35] Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, *The Origins of the Financial Crisis* (2008) Fixing Finance Series – Issue 3-34

[36] Julia M. Whitehead and H. Sean Mathis, *Finding a Way Out of the Rating Agency Morass* (2007) Prepared statement submitted to the House Committee on Financial Services 2

[37] Joshua Coval, Jakub Jurek & Erik Stafford, *"Re-Examining the Role of Rating Agencies: Lessons from Structured Finance"* [2008]

38 Dieter Kerwer, *"Holding Global Regulators Accountable: The Case of Credit Rating Agencies"* (Working paper 11, University College London 2004)

to reduce the cost of funding. This is of course in addition to their main function.[39] As will be seen in the second chapter, this "run-the-show" reality is heavily criticised since it results in conflict of interests of the credit rating agencies.

[39] Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, *The Origins of the Financial Crisis* (2008) Fixing Finance Series – Issue 3-34

Chapter two: The role of the elements of the credit risk assessment in the Global Financial Crisis

Introduction: setting the scene

In fact, the Global Financial Crisis that took place in the recent decade is considered the worst since the great depression 1929. According to the perception that it was based on the house bubble, as will be further discussed hereunder, the Crisis can be traced from 1990s. However, the manifestations of the Crisis have started to come into existence in 2007.

The implications of the Financial Crisis can be translated into serious global recession. The Crisis had become clearly apparent in July 2007 when the current Chairman of the United States Federal Reserve, Ben Shalom Bernanke, estimated the losses associated with the US subprime market $100bn. A year later, US Freddie Mac and Fannie Mae have been nationalized at a cost of $200bn, Leman Bros has collapsed and Merrill Lynch has been sold to Bank of America.[40]

Why the Financial Crisis?

The increased prices of houses and the introduction of securitisation are, among other things, the main constituents of the Crisis.[41] Historically, The US housing sector had been booming since 1990s. This may be evidenced by the fact that US homeownership rate rose from 65.7% to 68.9% in an eight-year period to be calculated from 1997.[42] This had encouraged the investments to intensively be made in such sector.

Simultaneously, the said bubble in the housing market had flourished the sub-prime lending[43] market by inducing commercial and investment banks to lend money to house owners through making mortgages secured on the houses owned by the prospective borrowers. The usage of what so called "Collateralized Debt Obligations"

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[40] G A Walker, *Global Financial Crisis* - *Timeline*, Butterworths Journal of International Banking and Financial Law

[41] Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, *The Origins of the Financial Crisis* (2008) Fixing Finance Series – Issue 3-7

[42] Robert J. Shiller, *The subprime solution: how today's global financial crisis happened, and what to do about it* (Princeton University Press, Princeton 2008) 5

[43] Sub-prime lending refers to the process of making loans that are in the riskiest category of consumer loans and are typically sold in a separate market from prime loans.

(CDOs) in which the pool is made up of asset-backed securities such as commercial mortgage-backed securities or residential-backed securities[44] was the method that had been used by the banks in pursuing such type of sub-prime lending.

The said two factors, i.e. fast rate of house price appreciation and the usage of the off-balance sheet transactions to finance the sub-prime borrowers, had resulted in the lending standards been declined dramatically. On one side, lenders were gambling on the continuing rise in the house prices and, hence, can enforce their rights against any borrower in default by liquidating the collateral. On the other side, the increased recourse to the off-balance sheet transactions, e.g. securitisation, had contributed in the lending standards being decreased since such a way of providing funds hedges risks to other investors rather than the originator.[45]

Additionally, the Global Financial Crisis can also, to some extent, be attributed to the lax regulatory framework which used to govern the financial markets by encouraging the excessive leverage and maturity transformation by banks.[46] Simultaneously, senior officials in almost all financial institutions were supporting the maximization of risks and, accordingly, the leverage so as to individually benefit from the bonuses.[47]

For the sake of completeness, it is relevant to expand the discussion to cover the reasons which transformed the Crisis from an internal crisis, originally took place in the US financial markets, into a “Global” one. One of these reasons is the existence of a similar bubble in the real estate prices in Europe. However, the house prices in the US had declined more dramatically than their counterpart in the European zone, justifying the effects being more sever in the US than in the EU.[48]

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[44] G A Walker, *Structured Finance* (Web CT, Queen Mary – University of London) note 44, accessed on July 2010

[45] Andrew Felton and Carmen Reinhart, *The First Global Financial Crisis of the 21st Century* (Centre for Economic Policy Research, London 2008) 8

[46] Jacopo Carmassi, Daniel Gros and Stefano Micossi, *“The Global Financial Crisis: Causes and Cures”* (2009) JCMS Volume 47 No.5 pp.977

[47] James Crotty, *“Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture’”* (2009) 33 Cambridge Journal of Economics 565

[48] Jacopo Carmassi, Daniel Gros and Stefano Micossi, *“The Global Financial Crisis: Causes and Cures”* (2009) JCMS Volume 47 No.5 pp.982-983

Moreover, the sudden collapse of the financial market in the US, justified by the previous causes, had led to a "subsequent global loss of confident" in the asset-backed securities. Consequently, banks all over the world felt that they are, somehow, obliged to keep as much cash as they can to face any liquidity claims. This rendered the international inter-bank market ineffective.[49]

The role of the due diligence process in the Financial Crisis:

As previously mentioned in the first chapter, the due diligence in the structured finance transactions are supposed to be exercised by the originators and the arrangers. The rating agencies will merely pursue an "objective and analytical assessment of the reference assets and the ability of the relevant issuer to meet its debt repayment commitments"[50] relying on the information verified by the originator during the due diligence conducted thereby.

As the discussion mainly concerns the causal relationship between the due diligence process and the Global Financial Crisis, it is well perceived that investors and originators of US mortgage-backed securities had given little attention to the process of due diligence while assessing the risks associated with such securities relying more heavily on the assessment of other third parties and institutions such as rating agencies.[51] In other words, the consistent lack of due diligence which was supposed to be performed by the lending institutions is deemed to be one of the prominent reasons for triggering the Crisis. In some instances, end-investors in the securitisation chain did not give the due care to know even the basic information about the companies in their portfolios, e.g. the name of the companies borrowing funds.[52]

The alleged casual relationship between the insufficiency of due diligence and the Crisis can be further supported by what was stated by the Italian Central Bank

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[49] Maximilian J.B. Hall, *"The Sub-prime Crisis, the Credit Squeeze and Northern Rock: the Lessons to Be Learned"* (2008) Journal of Finance Regulation and Compliance 1-2

[50] Thomas Ross, *"The Role of Rating Agencies and Their Potential Exposure in the Ongoing Credit Crisis"* (2008) 7 JIBFL 349 2

[51] Josef Ackermann, *"The Sub-prime Crisis and Its Consequences"* (2008) 4 Journal of Financial Stability 336

[52] Andrew G Haldane, *"Rethinking the Financial Network"* (2009) Speech delivered at the Financial Student Association, Amsterdam 16

Governor Mario Draghi at the G7 meeting in Tokyo. In his attempt to analyse the causes of the Crisis, Draghi mentioned "poor due diligence practices, including excessive and misplaced reliance of credit rating agencies" as one out of three causes of the Crisis.[53]

As a matter of fact, several reasons can be put in place justifying the due diligence being ignored by the originators' and investors' side and the excessive reliance on the rating agencies to assess the credit worthiness of borrowers:

- From an economic perspective, it is very costly for each investor investing in CDOs securities to conduct its own due diligence to assess the risks associated with its investments leaving such task to the rating agencies which will do it on behalf of many investors. Thus, the economies of scale, a concept which describes the negative relationship between the cost and the size, will be realised in the case of rating agencies while disturbed in the case of individual investors.[54]

- Linked to the first reason, it is not only expensive for the ultimate investors in the CDOs chain to conduct their own due diligence, rather it is unlikely for these investors to possess the required skills and information necessary to assess the risks implied in the debts involved.[55] However, lack of necessary information to conduct a proper due diligence cannot be considered as an excuse with the existence of services like LoanPerformance (www.loanperformance.com) and Intex Solutions (www.intex.com). Such services could have been used by the investors of CDOs to facilitate the access to detailed underlying loan-level information.[56]

[53] Andrew Felton and Carmen Reinhart, *The First Global Financial Crisis of the 21st Century* (Centre for Economic Policy Research, London 2008) 45
[54] Steven L. Schwarcz, *"Protecting Financial Markets: Lessons from the Sub-prime Mortgage Meltdown"* (2009) 2 Minnesota Law Review 10
[55] Mark Fox and H. Lane David, *"Lessons from the US Sub-prime Mortgage Crisis"* (2008) 449 JIBLR 2
[56] International Monetary Funds, *"Global Financial Stability Reports: Navigating the Financial Challenging Ahead"* (9 October 2009) 96

- The increased number of the brokers and other financial intermediaries rather than banks constitutes an additional reason justifying the descent in the due diligence standards. Statistically speaking, between 63 to 81 per cent of sub-prime loans were originated from the financial brokers in 2006.[57] Unfortunately, these "new players" did not have the sufficient credit skills to conduct proper due diligence with respect to potential obligors.[58]

- As can be concluded from chapter one, most of the CDOs involve the "originate-to-distribute" model rather than "originate-to-hold".[59] Such model gives no incentives to originators, either banks or brokers, to conduct a proper due diligence, since they pass off the risks to third parties.[60]

- Additionally, a properly conducted due diligence usually increases the liquidity risk, that is to be carried by the originators, through increasing the length of the sale period.[61]

- Moreover, the asymmetry of information which characterises the securitisation process may be deemed as a constraint against conducting a good quality due diligence. This is due to the fact that in the securitisation chain always one party has more and better information than the other party in the transaction concerned.[62]

- Also, Credit rating agencies were indirectly involved in the standards of due diligence being declined. As will be discussed later in this chapter, credit rating agencies were not transparent in terms of the methodologies, models

[57] n49

[58] Michael Mah-Hui Lim, "*Sub-prime Mortgage Crisis – Causes and Consequences*" (2008) 3 JARAF 6

[59] Originate-to-distribute model refers to the process which starts from the bank lending money to its borrowers and ends by bank selling its assets, i.e. loans and mortgage, to other investors. Thus, distributing the credit risks to these investors. Amiyatosh Purnanandam, "*Originate-to-Distribute Model and the Subprime Mortgage Crisis*" [2010]

[60] n49

[61] n32 13

[62] Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, *The Origins of the Financial Crisis* (2008) Fixing Finance Series – Issue 3 9

and assumption they were using to assess the risk. This deprived the originators and investors to conduct better unified due diligence process.[63]

In summary, it is now crystal clear that originators and ultimate investors had played an essential role in the financial meltdown by ignoring the importance of the due diligence in the financial markets relying solely on the credit rating agencies.

The role of credit ratings in the Global Financial Crisis:

It is indisputable that the credit rating agencies played an intrinsic role in the Crisis. Obviously, the risks were associated with the CDOs had not been assessed properly thereby. It is worth mentioning that the rating crisis, defined as unexpected and exceedingly sudden credit rating downgrades, are very frequent and not peculiar to the Global Financial Crisis. Owing to the last twenty two years, rating crisis was happening every three years.[64]

In the last Crisis, many factors had driven the credit rating agencies, either intentionally or unintentionally, to assign high ratings to bad debts. The following is a non-exhaustive list of these factors:

- **Conflict of interests:** On one hand, during 1970s credit rating agencies have moved from a "subscriber-pay" to an "issuer-pay" model**.**[65] This basically means that the rating agencies are paid by the issuers or the originators, in case of structured finance, to serve the ultimate investors. In this regard, reference shall be made to the securities rated by the rating agencies to be sold to the institutional investors. It is well perceived that institutional investors, e.g. pension funds, insurance companies and hedge funds, are restricted from investing in securities unless rated at least one rating from a recognized credit rating agency. Accordingly, Originators were trying to

[63] Ed, "*Improved supervision of CRAs and corporate governance in financial sector proposed*" [2010] EU Focus
[64] Amadou N.R. Sy, "*The Systemic Regulation of Credit Rating Agencies and Rated Markets*", [2009] IMF Working Paper
[65] Deniz Coskun, *"Supervision of Credit Rating Agencies: the Role of Credit Rating Agencies in Finance Decisions"* [2009] JIBLR 2

have access to these wealthy investors through inducing the rating agencies to assign high ratings to their securities.[66]

On the other hand, there is a likely existence of conflict of interests between the credit rating agencies as consultants for the originators and, simultaneously, as institutions responsible for rating the products to which the consultations relate. The credit rating agency that has been consulted on the creation of structure financial product may then seek to rate the same product. Hence, it will be practically impermissible to turn around and give a lower rating than the one sought by the issuer based on the advice previously received from the same agency while acting as a consultant.[67]

Such a claim may be rebutted by the credit rating agencies' argument that their job heavily relies on the public confidence in their integrity. If they really were running contradictory interests, they would have suffered a loss of public confidence and, on the long run, lost their entire business![68]

- **The nature of the structured finance transactions:** As explained in the first chapter, the main purpose of securitisation is to transfer the risks to other investors rather than the originator. For the originator, the whole transaction will be pursued off its balance sheet. Accordingly, the originator neglects to provide the rating agencies with the sufficient information required to conduct an accurate analysis of the underlying assets.[69]

- **The liability issue:** Unfortunately, The civil-law liability of credit rating agencies does not provide enough protection for the investors. It is impossible to find that the credit rating agencies have been successfully held liable for their bad doings. In US, for example, credit rating agencies are

[66] Tom Hurst, *"The Role of Credit Rating Agencies in the Current Worldwide Financial Crisis"* [2009] Company Lawyer
[67] n58
[68] n5b
69 Michael Nwogugu, "*Illegality of Securitisation: Bankruptcy Issues and theories of Securitisation"* [2008] JIBLR 363

totally exempted from prospectus liability.[70] Such protection bestowed upon the rating agencies had led them not to fulfil their credit analysis with the necessary due care.

- **Insufficient resources:** As has been discovered in the previous chapter, structured finance is very complex. Credit rating agencies were lacking the skilful staff to perfectly perform their tasks related to the assessment of the CDOs.[71]

- **Applying wrong models:** The analytical comparison previously approached on the first chapter expressly reveals that the models that might be utilised in issuing corporate bonds do not appeal to bonds issued through the process of securitisation. It is now obvious that the second type of bonds is more complex as it involves more parties and more variant factors than the first type. Before the Global Financial Crisis, credit rating agencies were relying on the old repeatedly tested models of corporate bonds to assess newly structured products.[72]

  Moreover, the givens used by these models to calculate the likely percentage of default of borrowers on the mortgage pool were based on old historical default rates taken from 1992 until 2000s, a period in which default rates were low and home prices were raising. Thus, the usage of these rates, which were used as givens in the CDOs credit analysis, by the credit rating agencies was unacceptable as they did not reflect the status of the financial markets at the time the Crisis triggered.[73]

- **Natural monopoly:** In fact credit ratings market is characterised by natural monopoly. This is due to the fact that increasing the participants of the ratings market will disturb the consistency of ratings across the issuers.[74]

[70] n58
[71] n85
[72] Alejo Czerwonko, *"Understanding the U.S. Residential Subprime Mortgage Market and Its Relation to the 2007 Financial Crisis"* [2010]
[73] n23
[74] John Goddard, Phil Molyneux and John O.S.Wilson, *"The Financial Crisis in Europe: Evolution, Policy Responses and Lessons for the Future"*

Additionally, the regulatory licence recognised by the Securities and Exchange Commission is enjoyed only by a limited number of rating agencies. Such monopoly limits innovations in rating methodologies.[75]

- **Failure to downgrade:** With reference to the first chapter, credit rating agencies not only rate the securities upon issuance. Rather, rating agencies shall review the securities assessed thereby periodically in order for the rating assigned to reflect the true value of the security concerned at each single time.

  In respect of the Global Financial Crisis, "Credit rating agencies have been frequently criticised for being slow to recognise a decline in the creditworthiness of an issuer and to downgrade its securities only after the market has already recognised that an issuer's finances have deteriorated".[76]

[75] Angus Duff, *"The Credit Rating Agencies and Stakeholder Relations: Issues for Regulators"* (2009) 1 JIBFL 11

[76] n58

Chapter Three: Regulatory responses and further reforms

Introduction:

Although the Global Financial Crisis has negatively affected the global economy, it forced the financial regulators to review the regulatory framework that were governing the financial sector. Furthermore, scholars and commentators started to suggest further reforms in order to avoid further crises.

This chapter will be dedicated mainly to address the regulatory responses and the suggested reforms which took place after the Global Financial Crisis. To specify the scope of discussion in this chapter, the trajectory which will be observed and traced is that of the US and EU financial regulations.

Similar to the previous two chapters, the current chapter is structured to address the suggested reforms and regulatory initiatives regarding the due diligence process proceeded by the reforms and suggestions for credit ratings.

- **Enhancing the due diligence process:**

The conclusion reached in the second chapter concerning the casual relationship between the ignorance of due diligence and the Global Financial Crisis asserted the need for an appropriate regulatory framework that contains minimum standards to which the originators and investors are obliged to follow while conducting their due diligence. As banks are the core of the financial system, the robustness of the financial sector will depend to a great extent on how banks, as originators, perform their due diligence as an indispensable procedure of their risk analysis. [77] As provided for in the recital 27 European Directive (3670/09) updating the capital requirements for banks:

> *"Due diligence should be used in order properly to assess the risks arising from securitisation exposures for both the trading book and the*

[77] Mike I. Obadan, *"Globalization of Finance and the Challenge of National Financial Sector Development"* (2006) 17 Journal of Asian Economics 324

non-trading book. In addition, due diligence obligations need to be proportionate. Due diligence procedures should contribute to building greater confidence between originators, sponsors and investors"

Due to the fact that due diligence is supposed to be performed by both the originator and the ultimate investors, the suggested reforms and regulatory responses can be divided according to the subject matter thereof. Thus, the issue of enhancing the due diligence process will, primarily, be dealt with from the originators' side and then from the investors' side.

1. <u>Conducting the due diligence by originators:</u>

- It has been stated previously that one of the reasons which induces the originator not to conduct a proper due diligence is that, in structured financial transactions, the originator usually apply "originate-to-distribute" model, a model which basically passes the risks off to the investors. Consequently, it is suggested that originators should be required to hold a specified minimum percentage of the equity portion of the structure they sell. The application of the said proposal will make the originator bear the direct costs which may ensue from ineffective misleading risk assessment and, hence, motivate the originators to exercise effective due diligence.[78]

- Additionally, to solve the asymmetry of information that characterises the process of securitisation, transparency obligations and disclosure requirements shall be imposed by the financial regulators upon the issuers and originators of the structured finance products in order to provide a better access for investors to the financial data required to perform their efficient due diligence.[79] After the Global Financial Crisis, Several organisations and institutions asserted the need for the existence of such obligations and requirements and took the initiatives to test the prevailing disclosure practices in the financial markets.

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[78] Michel G. Crouhy, Robert A. Jarrow and Stuart M. Turnbull, *"The Sub-prime Credit Crisis 07"* (2008) 36

[79] Hugo Benziger, *"Setting the Right Framework for Modern Financial Markets: Lessons Learned from the Recent Crisis"* [2008] FSR 12

In the EU, the European Directive (3670/09) updating the capital requirements for banks has increased originators' the transparency obligations as a way to enhance the regulatory framework that governs the securitisation practices.[80] Furthermore, on the EU level also, a proposal for a directive on "Alternative Investment Fund Managers" is currently in process. One of the operational objectives that will be achieved through the said proposed directive is to "Reduce potential for weakness in investor disclosures as barrier to effective due diligence".[81]

On the international plane, the International Organisation of Securities Commission (IOSCO) Task Force recommended the Standing Committee on Multinational Disclosure and Accounting to disclosure standards applicable to asset-backed securities. The recommendation instructs the Committee to develop international principles regarding the disclosure requirements if the existing standards seen as insufficient or ineffective.[82]

2. <u>Conducting the due diligence by the investors:</u>

It is now firmly established that the lack in the due diligence by the ultimate investors in the securitisation chain and their over reliance on the credit rating agencies is one of the reasons of the Financial Crisis. The said over reliance question can be partially solved by forcing certain types of investors to conduct their own due diligence according to minimum standards to be stipulated upon in the relevant regulations.

For instance, the Financial Industry Regulatory Authority (FINRA) obliged the broker-dealers to conduct "reasonable" investigations of the issuer. Such an obligation can be found on the FINRA regulatory notice 10-22 (the "Notice"). The Notice expresses no exemption from the said obligation even if the investor is sufficiently sophisticated or high accredited. The degree of the due diligence required by FINRA

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[80] Council of the European Union, *"Financial Services: New Rules on Credit Rating Agencies, Bank Capital Requirements, Cross-border Payments and E-money, and a program to support the Effectiveness of EU Policies"* (Press 243) (27 July 2009) 12380/09
[81] Commission of the European Communities, *"Proposal for a Directive of the European Parliament and the Council on Alternative Investment Fund Managers"* (Impact Assessment) SEC(2009) 576 31
[82] IOCU-IOSCO, "Recommendations to Address Sub-prime Crisis" (Media Release) (29 May 2008) IOSCO/MR/007/2008

has been strengthened, e.g. no oral statements without verification can be accepted as due diligence.[83]

- **<u>Regulating the credit rating agencies:</u>**

After the Global Financial Crisis, credit rating agencies have received huge criticisms. They are considered one of the main reasons for the Crisis. Clearly, they failed to assess the risks accompanied the CDOs properly. The factors for such failure have been previously stated in the second chapter.

In the following discussion will focus on the reforms suggested to enhance credit ratings together with the regulatory developments concerning the credit rating agencies. However, in order to understand the regulatory responses against the Global Financial Crisis in relation to the credit rating agencies, a brief reference to the old credit rating agencies regulatory structure is a must.

Thus, to address these aims, this part will be divided into three sub-parts. The first sub-part will be dedicated to mention the solutions proposed by several scholars to improve the rating process focusing, mainly, on the rating of the structured finance products. The second sub-part will be devoted to give a historical review regarding the old regulations used to govern the credit rating agencies. Finally, the regulatory responses to the Global financial Crisis with respect to the rating agencies will be tested in the last sub-part.

1. **<u>The suggested solutions:</u>**

After mentioning the factors contributed to the credit rating agencies' failure to assess the risks of the structure products, it is now the time to state some of the suggestions and proposals which have been put in place to eliminate these factors or their effects on the credit risk assessment:

[83] Hugh H. Makens, *"Due Diligence in Private Placements"* ALI-ABA Seminar/audio Webcast (15June 2010)

- It has been stated in the first chapter that credit rating agencies “run the show” in structured finance transactions as they are not only rating the securities but also advice and consult originators on how to construct their transactions. Such reality has been identified in the second chapter as a conflict of interests. To resolve this conflict, it has been proposed that separating rating from consultancy and advisory roles and making the credit rating agencies one-product firm is the right solution therefore.[84]

  Even selling other services and products which are not in conflict with the rating process are not acceptable since this will incentivise the credit rating agencies to bias ratings against taking more business in unrelated areas. Thus, establishing Chinese walls will not suffice.[85] However, politically speaking, obliging the credit rating agencies to give up their highly remunerative advisory works is not an easy task to fulfil.[86]

  Although it is a key asset to the credit rating agencies, it has been argued that reputation consideration, previously discussed in the second chapter as we are talking about the question of conflict of interest, cannot be considered as a sufficient shield against the issue of conflict of interests. This is due to the fact that individual employees of the credit rating agencies can be biased to earn more personal benefits on the expense of the agency’s interests.[87]

- As submitted before, the credit rating agencies follow the “issuer-pay” model rather than the “subscriber-pay” model. This is in order to avoid the free-rider problem. It has been also submitted that the said model induced the credit rating agencies to underestimate the risks to justify their assigned high ratings so as to attract more issuer and, hence, earn more profits. To conflict of interests resulted from such method of payment; it has been suggested to construct a representative body for the investor side of the market. An amount of money will be levied on the firms in the industry concerned to finance such

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[84] Richard Portes, *“The First Global Financial Crisis of the 21st Century: Ratings Agency Reform”* (Centre for Economic Policy Research, London 2008) 145-149
[85] Willem H. Buiter, *“Lessons from the North Atlantic Financial Crisis”* [2008]
[86] n84
[87] n85

body. Conceivably, security issuer could also be asked to contribute according to the pool out of which rating fees are paid; this would be joint payment of the rating agency by both sides of the security markets.[88]

- Moreover, the Tripoli policy that is currently taking place is unlikely to be optimal. The implementation of Solution A, i.e. forcing credit rating agencies to become single-product firms, entails the promotion of the competition. However, new entrants will inevitably take long time to build their own reputation.[89]

- Furthermore, many commentators have proposed many amendments in relation to the methods used by the credit rating agencies to assess the risk. For example, some suggested that standardisation of ratings across agencies would be helpful. Others have proposed that regulators should ask the credit rating agencies to provide more information rather than just assigning specific rating as this will give the investors a clearer idea about the securities in which they invest.[90] Similarly, financial analysts preferred a range for the risks of each instrument to be given by the credit rating agencies instead of merely assigning a point estimate.[91]

2. **The regulatory framework of credit rating agencies before the Global Financial Crisis:**

In this part, regulations related to the credit rating agencies which prevailed before the Global Financial Crisis will be tested. As mentioned before, the review in place will be limited to the US and EU regulatory framework.

[88] n85
[89] n85
[90] n84
[91] R. Ferguson, P. Hartmann, F. Panetta and R. Portes (2007), International Financial Stability, CEPR and ICMB

US regulations before the Global Financial Crisis:

In 1970s the US Securities and Exchange Commission (SEC) commenced an informal process of accrediting credit rating agencies through conferring the Nationally Recognised Statistical Rating Organisations (NRSROs) designation. This designation was used by regulated entities, e.g. mutual funds and brokerage companies, as a mean to rely on the credit rating agencies to fulfil certain regulatory conditions.[92]

In 2006, the congress passed the Credit Rating Agency Reform Act. The Act gave the SEC more explicit powers. These powers included the authority of the SEC to oblige the credit rating agencies elected to be NRSROs to register therewith and to be adhered by specific requirements. “These include periodic reporting on activities and the public disclosure of information on internal standards and policies as well as rating methodology and performance. The act also empowered the SEC to conduct on-site inspections of rating agencies and to take disciplinary action for violations of the law. But it prohibited the SEC from regulating the credit rating process, including the procedures and methodologies used. The relevant rules were adopted in 2007 and revised in 2009”.[93]

EU regulation before the Global Financial Crisis:

The credit rating agencies in the EU were mainly governed by three instruments:

- The Market Abuse Directive (MAD): In which the prohibition of market manipulation will be applied on the credit rating agencies in case they knew or ought to have known that their ratings were false or misleading.

- The Capital Requirements Directive (CRD): put the standards by which the credit rating agencies can be recognised as provide adequate ratings to be utilised by banks while calculating their capital adequacy requirements.

[92] Jonathan Katz, Emanuel Salinas and Constantinos Stephanou, *“Credit Rating Agencies: No Easy Regulatory Solutions”* (2009) 3 The World Bank Group – Financial and Privet Sector Development Vice-Presidency
[93] n92

- The International Organisation of Securities Commissions (IOSCO) Code: In fact, this code is voluntary. It aimed to instruct the credit rating agencies on how to exercise their duties properly and to avoid any conflict of interests or any other internal operations affecting integrity and quality of their risk assessment. The Code had been drafted in a way that allows all the credit rating agencies around the world to apply it. In other words, the Code only contained a set of high-level principles, leaving the details and the way of implementation to the credit rating agency as it sees fit according to the jurisdiction in which it operates.[94]

3 The developments in the regulation of credit rating agencies

After stating the solutions proposed and the old regulatory structure that used to govern the credit rating agencies. It is now the right place to observe the developments in the regulation of credit rating agencies which took place after the Global Financial Crisis. The reason for locating the said developments in this late stage is to create an ability to compare between the old and the new regulatory framework and to chick whether any of the abovementioned solutions has been adopted by the regulators.

- **The US new regulatory framework:**

The SEC has approved many amendments related to its rules that govern the credit rating agencies in December 2008. These amendments have given the right to the SEC's staff to extensively examine the Big-three credit rating agencies for ten months. Moreover, the said amendments aimed at increasing transparency and accountability.[95]

[94] Edmund Parker and Miles Bake, *"Regulation of Credit Rating Agencies in Europe"* [2009] Butterworths Journal of International Banking and Financial Law 401-403

[95] Shearman & Sterling LLP, *"EU and US Developments in the Regulation of Credit Rating Agencies"* [2009] Financial Institutions Advisory.

"The new rules affect the credit NRSROs' record keeping procedures, conflict of interest rules, annual reporting methods and disclosure practices"[96]

- The SEC's new rules require the NRSROs

    - to make and retain records of all rating actions related to a current rating;

    - to make a record documenting the rationale for any material difference between the credit rating implied by a quantitative model used and the final credit rating issued if the model is a substantial component of the credit rating process; and

    - to retain records of any complaints regarding the performance of a credit analyst in determining or maintaining a credit rating.[97]

- Additionally the SEC'S new rules related to the conflict of interests forbid

    - an NRSRO from issuing a credit rating where the NRSRO has made recommendations to the issuer in respect of the structure of the financial instrument that is to be rated or in respect of the issuer's activities;

    - personnel of the NRSRO who are responsible for determining the credit ratings from participating in any fee discussions and negotiations; and

    - credit analysts who participated in determining the credit rating from receiving gifts, including entertainment, in excess of $25

[96] n95
[97] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342 (February 2, 2009) ("SEC Final Rule"), pp. 16-31

(other than in limited circumstances such as business meetings) from the rated issuer.[98]

- **The EU new regulatory framework**

After the Global Financial Crisis, the voluntary IOSCO Code together with the existing Directives were seen as insufficient by the EU financial regulators. The EU decided to move from the light touch regulation as it proved inefficient. As a result, the Regulation No 1060/2009 on Credit Rating Agencies (the "regulation") was proposed by the Commission in November 2008 but came into force in April 2009.[99]

The Regulation aims at reforming the ratings market so as to avoid any further crisis. It contains rules relating to the conflict of interests, skills of the credit rating agencies' employee and disclosure requirements.

As for the issue of conflict of interest, the Regulation requires:

> "A credit rating agency shall take all necessary steps to ensure that the issuing of a credit rating is not affected by any existing or potential conflict of interest or business relationship involving the credit rating agency issuing the credit rating, its managers, rating analysts, employees, any other natural person whose services are placed at the disposal or under the control of the credit rating agency, or any person directly or indirectly linked to it by control".[100]

As has been stated in the in the second chapter, the credit rating agency were lacking the skilful staff to assess the risks associated with complex financial products like CDOs. In fact, this issue has been dealt with in the Regulation:

[98] SEC Final Rule, pp. 38-51
[99] n94
[100] Article 6 - 1

> “A credit rating agency shall ensure that rating analysts, its employees and any other natural person whose services are placed at its disposal or under its control and who are directly involved in credit rating activities have appropriate knowledge and experience for the duties assigned”.[101]

Additionally, the Regulation enhances the transparency in the ratings market through forcing the credit rating agencies to disclose their methods in assessing the credit risks and their credit ratings

> “A credit rating agency shall disclose to the public the methodologies, models and key rating assumptions it uses in its credit rating activities”[102]

> “A credit rating agency shall disclose any credit rating, as well as any decision to discontinue a credit rating, on a non-selective basis and in a timely manner. In the event of a decision to discontinue a credit rating, the information disclosed shall include full reasons for the decision”[103]

- **Concluding remarks:**

After examining the regulatory reforms conducted by the EU and US financial regulators, it is now clear that the regulators realised the need for a framework that promote the transparency and foster competition in the ratings market and can deal effectively with the issue of conflict of interests. An analytical comparison between the US and the EU reforms reveals that both regimes aimed at accomplishing the same goals.

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[101] Article 7 - 1
[102] Article 8 - 1
[103] Article 10 - 1

Conclusion

It is now obvious that the main reason for the Global Financial Crisis is the ineffective assessment of the risks associated with the bonds issued through securitisation. From one side, investors did not conduct proper due diligence, relying on the ratings assigned by the credit rating agencies. Moreover, the process of the credit rating was defective because of the contradicted interests of the credit rating agencies and the complexity of the structured finance transactions.

Consequently, regulators decided to interfere and regulate the elements of the credit risk assessment disturbing the principle of light-touch regulation and self-regulation. This is in order to insure the investors are conducting the due diligence they supposed to conduct from one side and, from the other side, the integrity of the credit ratings assigned by the credit rating agencies.