Credit Rating Agency Regulation in the UK If and When Article 50 is Invoked: Round Holes for a Square Peg?

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The decision taken by British voters to leave the European Union has created uncertainty in all walks of life, ranging from everyday concerns to professional anxiety. In this article, the focus is on the UK’s regulation of the Credit Rating Industry if and when Article 50 is invoked. The aim of the article is to examine some potential options available to policymakers and legislators in terms of their validity for taking on such an important task.

Whilst it is not guaranteed that the UK will take sole responsibility for the regulation of credit rating agencies in its jurisdiction, it is likely. Therefore, assessing the credentials of the relevant agencies is a worthwhile endeavour. Yet, each option comes with its own set of issues, as will be discussed, so the article concludes by offering an option that may negate such issues whilst continuing to regulate the credit rating agencies efficiently and effectively.

Introduction

As this article is concerned with what may happen if and when Article 50 is invoked, thus triggering the UK’s secession from the European Union, it is important to begin with a number of caveats. Given the multitude of factors that may occur in the coming months (and potentially years), it is near impossible to speak with any certainty. So, with this in mind, the article operates on a number of premises that need to be expressed. Firstly, it is assumed here

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that the UK Government *will* trigger Article 50 and begin the secession from the European Union; a number of prominent onlookers have suggested that this will not be the case (owing to the referendum result not being binding)\(^1\), but this article will not analyse those issues in any great depth. Secondly, the options discussed in this article are those that are the *most likely* to be considered by the UK Government should they be forced to regulate the rating industry directly; it is possible that a different regulatory path is taken (even creating a new regulator), but those considerations are far too abstract for this analysis. Also, and as will be discussed shortly, it is possible that the UK and EU will come to an arrangement where many of the current agreements in place remain, thus making this analysis purely academic; this may happen, but it is far from certain – the threat of a ‘hard-brexit’ may not come to fruition. Lastly, it may be the case that the Credit Rating Agencies leave the U.K. entirely, in which case the issue will be how the U.K. seeks to influence the actions of the agencies who would be passing judgement on British entities, but would not be physically present within their jurisdiction. With all that in mind, it is useful then to ask what the aim of this article is.

This article has a number of research questions. To begin with it will be important to ask **how is the credit rating industry currently regulated in the UK?** Asking this question will give us an insight into the likelihood of the regime being maintained after the UK leaves the Union. We shall see in a moment that whilst the current system may be maintained because of the intricacy of the arrangement, there are a number of extremely important factors that threaten that system being retained, including issues of sovereignty, national economy, and

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\(^1\) One prominent onlooker, Kenneth Clarke MP, suggests that MPs will block the Government from triggering Article 50 (The Government, for its part, suggests that it will not be consulting Parliament on the decision; this approach has been deemed ‘constitutionally inappropriate’ by a House of Lords Committee) see Anushka Asthana and Rowena Mason, *Ken Clarke Tells Constituents: ‘EU referendum is not binding’* The Guardian (13 Sept. 2016); House of Lords Select Committee *The Invoking of Article 50* (2016).
world standing. If this arrangement cannot be maintained, then it will be prudent to ask **what are the options available within the UK regulatory framework for regulating the credit rating industry?** At the moment there is a regulator, the Financial Conduct Authority (FCA), which has been given the status of ‘competent authority’ in terms of supervising credit rating agencies in the UK so that they observe the rules set by the EU. However, there are a number of issues with the FCA that need to be considered which, in essence, means that the transition from supervisor to direct regulator is not as straightforward as it should be. Also, other regulators have certain strengths that may make the decision of selecting a regulator that bit more complicated. Therefore, upon analysing each of these options, the article will be asking **how appropriate are these options?** Furthermore, the pre-eminence of the former Financial Services Authority (FSA), the European Securities and Markets Authority (ESMA), and the Securities and Exchange Commission (SEC) in the USA are all examples of regulators that dominate(d) their regulatory frameworks; the new framework in the UK is based on one of collaboration, so the article will ask then sensible question of **how may the choice of regulator be optimised?** There is an argument to be had that collaboration between agencies may improve the effectiveness of rating agency oversight. However, the recent history of credit rating regulation, on both sides of the Atlantic Ocean, suggests that we should be highly critical of any option available, so the article will conclude by asking **how likely is it that an optimised approach will be implemented?**

Whilst it is important to proclaim what the article will cover, it is arguably even more important to look at what it will not cover. This is because of simple aspect – uncertainty. With the uncertain nature of a secession from an economic bloc, particularly within the world that we live in today, the analysis of this article could go on to fill volumes. There are important questions which may be asked, but are perhaps best reserved for either another
piece, or another time. Firstly, it is absolutely accepted that there may be no need whatsoever to discuss the British regulation of the agencies, because one of two things may occur. If the U.K. and the E.U. negotiate what is being labelled as a ‘soft-Brexit’, then it is highly likely that many regulatory arrangements will remain in place (probably including the ESMA regulation of the rating industry – financial regulation does not register in the public consciousness like other aspects of regulation do, for the most part). Also, if the rating agencies decide to rearrange their global positioning in response to Brexit and relocate their European subsidiaries to a European finance-Capital, like Paris or Frankfurt, then the U.K. is faced with a different proposition altogether. The issue then will be not how to regulate the industry, but how to attempt to influence the actions of an economically-important financial entity that does not have a presence within your jurisdiction – that analysis is certainly better reserved for another scholarly endeavour. This article therefore progresses forward with this major caveats in mind – however, at this point in time, academic analyses are useful but fraught with danger because, whilst we must try to be as critical as possible, we must remain focused. With that in mind, the article simply aims to facilitate a discussion on what may happen if the U.K. is forced to regulate the rating industry on its own terms.

The Current Regulatory Framework in the UK

All member states in the European Union are subject to the EU’s CRA III Regulation⁹, and under that regulation (and its predecessors) member states are required to designate a ‘competent authority’ from within its own regulatory framework to supervise the rating agencies within its jurisdiction, and also to assist the EU regulator given the responsibility for regulating financial service providers, the European Securities and Markets Authority

(ESMA). In 2010 the UK Government, by way of Statutory Instrument, designated the now defunct Financial Services Authority (FSA) as its ‘competent authority’; the disbanding of the FSA was recognised in a subsequent Statutory Instrument, within which the Financial Conduct Authority (FCA) was to be designated as the UK’s ‘competent authority’. The role of the FCA is, essentially, to conduct investigations on behalf of the ESMA and report breaches of the CRA III Regulation. The ESMA, in its role is the principal regulator for credit rating agencies in Europe, can also designate supervisory tasks to the FCA.

There is another layer of regulation in the UK, in a sense, and that comes in terms of civil liability. As detailed in the Statutory Instrument adopted in 2013, a claim for civil damages can be brought against the agencies if the potential claimant can provide accurate and detailed information that a CRA has either: committed an infringement of CRA III, and that the infringement had an ‘impact’ upon the credit rating; damages were caused because of the infringement; and that the claimant ‘relied’ on the rating. Even though there are a number of issues with the civil liability of rating agencies, the Statutory Instrument does still provide an extra layer of oversight and accountability against the agencies in the UK.

3 The Credit Rating Agencies Regulations 2010 (S.I. 2010/906).
5 Credit Rating Agencies (Civil Liability) Regulations 2013 (S.I. 2013/1637).
6 How to go about obtaining the ‘detailed and accurate’ information is another issue entirely, perhaps best demonstrated by the case of CalPERS in the US having to settle with Fitch Rating for incriminating information against Standard & Poor’s and Moody’s, rather than financial compensation, in order to obtain such ‘detailed and accurate’ information (the same concept of ‘proof’ is in place in the United States). For more see CalPERS, CalPERS to Recover More than $300 Million from Standard & Poor’s in Investment Ratings Settlements (2015). Also, the removal of the reference to ratings within official regulations, in both the US and the EU, means that proving that one ‘relied’ on a rating is equally as difficult. These are just two reasons why there have been very few civil cases even brought against the agencies.
The current framework, in terms of its interconnection with the EU, will be much debated in the coming months and years. Whether or not it continues in the current format will be dictated by some momentous political decisions. For example, writing for the Harvard Law School Forum on Corporate Governance and Financial Regulation, Davis Polk and Wardwell LLP Managing Partner Thomas J Reid suggests that as EU regulations state that EU financial institutions can only use ratings for regulatory purposes that have been issued by a CRA registered with ESMA, the UK as a ‘third country’ (the status it will assume if it leaves the EU completely) will not be an appropriate base for rating agencies that have designs on having their products purchased in Europe (as The Big Three of S&P, Moody’s and Fitch do). As a result, Reid suggests that CRAs may be ‘pressurised to move certain of their EU activities from the UK and into the EU, where these activities can be directly regulated by ESMA’. An alternative option, as discussed by Richard Whitman on behalf of Chatham House, is if the UK seeks to agree to a European Economic Area (EEA) relationship with the EU, which would result in the UK not being officially designated as a ‘third country’. This would, in effect, maintain the current system and leave ESMA as the principal regulator for CRAs within the UK. However, some of the most publicised issues during the referendum campaign were sovereignty and immigration, and this EEA membership arrangement would fly in the face of what was decided; Whitman correctly realises that the EEA membership arrangement would mean that the UK was still subordinate to the EU in terms of regulation in this particular field (and others), and also that EEA membership still requires the acceptance of the free-movement principle whilst losing the power to veto certain policies (Turkey’s ascension to the Union, for example). Therefore, whilst the EEA membership arrangement

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idea is, theoretically, an acceptable idea in the short-term, it is unlikely to be adopted owing to the reality of the arrangement.

On that basis it is now worth analysing the options available within the UK’s regulatory framework for taking over direct regulatory duties of the ratings industry. Supposing that Reid’s prophecy above, that CRAs will be pressurised into moving their operations into the EU after the triggering of Article 50, does not come to fruition, the strengths and weaknesses of UK regulators needs to be addressed. The current situation, whereby the FCA has only been supervising the agencies for the ESMA, leaves us with a remarkable opportunity to approach the regulating of the agencies from a new perspective; whether or not this opportunity is taken is another matter entirely. In the next three sub-sections we will be introduced to the three main components (arguably) of the UK’s regulatory framework that may be given the task of regulating the rating agencies: the Financial Reporting Council; the Prudential Regulation Authority; and the Financial Conduct Authority.

**The Financial Reporting Council**

It is worth mentioning before this subsection begins that both the Financial Reporting Council and the Prudential Regulation Authority are rank outsiders when it comes to being given the task of regulating the agencies post-brexit. The FCA, for reasons that will be discussed in the FCA’s subsection (but mostly because of its recent involvement with the regulation of CRAs) is the odds-on favourite to be given the responsibility. However, there are certain aspects of both the FRC and the PRA that mean to totally dismiss them could be a
mistake; regulating the agencies effectively and with the right aims in mind is crucial in this stage of the UK’s recovery from the Crisis, so analysing all available options is of crucial importance.

The Financial Reporting Council was borne out of the dissolution of the Accounting Standards Committee (ASC) in 1990. Sir Ronald Dearing would suggest, whilst reviewing the ASC, that the standard-setting process within the accountancy field should be changed, and with that recommendation came the establishment of the Financial Reporting Council with Dearing as its Chairman. On the face of it the FRC seems to be exclusively concerned with the accounting industry, but an analysis of their mission statement suggests that their scope could be broadened to include the regulation of credit rating agencies.

The FRC state that their mission is to ‘promote high quality corporate governance and reporting to foster investment’. They go on to state that ‘the capital markets are important to the health and growth of the economy… we help to ensure that investors have what they need to place their money with reasonable confidence that any risk is taken on an informed basis’. This mission is clearly in line with the issue of credit rating agency regulation, which should be concerned with helping to provide investors with clear and reliable information upon which they can choose the risk that they can afford to take.

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11 Id.
The FRC is indeed concerned with the accounting and actuarial industries, but it is also responsible for setting the UK Corporate Governance and Stewardship Codes. The FRC state that the UK Corporate Governance Code is based on the ‘underlying principles of good governance: accountability, transparency, probity and a focus on the sustainable success of an entity over the long term’\textsuperscript{12}. These aspects are crucial if the UK is to directly take on the task of regulating the credit rating agencies, mostly because any element of mis-regulation can have a lasting and extremely damaging effect, as we saw with the financial crisis that had the credit rating agencies at the centre of it. We need a regulator to be pushing to make rating agencies more transparent, more accountable, and to push them into focusing on their own and everyone else’s long-term success. In this sense, the FRC seems to be a potential avenue to consider.

However, there is one element of the FRC that arguably rules it out. One of the most important aspects of effective financial regulation, in terms of protecting investors (and more importantly the general public), is that the regulator must not be too close to the regulated entities; preferably, they should have no links to them at all unless it is to do with regulating them because of issues like the ‘revolving door’\textsuperscript{13} and ‘regulatory capture’\textsuperscript{14}. Criticisms of the FRC make for uncomfortable reading in this regard, because the set-up of the body raises a number of suspicions as to its independence. The first warning sign comes from the FRC itself, when they state that their approach is based ‘as far as possible on facilitation rather

\textsuperscript{12} Financial Reporting Council 2.
\textsuperscript{13} For a succinct explanation of the ‘revolving door’ concept, whereby regulators transition between regulatory office and the firms they are tasked with regulating, see Andrew Baker, Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance, 86 International Affairs 3 (2010).
\textsuperscript{14} There are a wide array of resources that discuss the nature of ‘regulatory capture’. For perhaps the most famous discussion see George J. Stigler The Theory of Economic Regulation 2 Bell Journal of Economics and Management Science 3 (1971).
than dictation and on principles rather than rules’. Whilst this facilitory approach is a genuine regulatory approach, it is no way appropriate for the credit rating industry due to its culture of maximising their position at the cost of investors (and arguably the same could be said of the accounting industry). What is worse than having a facilitory approach when regulating an industry that has proven itself to be callous in chasing profit is when the regulator depends on the regulated parties. The (BIS) Department for Business, Innovation & Skills (now called the Department for Business, Energy & Industrial Strategy) wrote in 2011 that ‘the FRC is insufficiently independent from the accountancy professional bodies’ and that ‘the independence of the FRC in this role is still governed by complex arrangements with the profession that sometimes inappropriately limit its independence and therefore its ability to pursue the public interest’. Even worse, the FRC ‘cannot launch an investigation until it has consulted the accountancy profession’. This remarkable understanding essentially discounts the FRC from being in the running to regulate the rating agencies, because to have these issues when regulating an industry like the rating industry could lead to a collapse much worse than the Financial Crisis.

The FRC has great aims in terms of regulating financial entities. However, its proximity to the regulated entities is disheartening to put it mildly. The performance of the accounting industry, in particular the Big Four firms, with regards to the financial crisis, was nothing

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16 There are a number of cases coming to light regarding the rating agencies abusing their position and fraudulently operating against the position of investors, with the CalPERS case being the most prominent. As for the accounting industry, the famous regulatory approach adopted after the scandals of the early 2000s had little to no impact upon their conduct, with the Big Four firms being prominent within the iniquities of marketplace in the lead up to the Crisis; facilitory regulation is not effective when faced with a certain culture. For more on the role of the Accounting firms in the Crisis see Malcolm Campbell-Verduyn, *Conflicts trends and tensions in post-crisis reforms of transnational accounting standards* in Tony Porter, *Transnational Financial Regulation After the Crisis* 182 (Routledge 2014).
short of scandalous. Recently, there have been claims that the FRC’s handling of the HBOS scandal is representative of the problems within the FRC, with one scholar claiming that the fact that the FRC’s Executive Director for conduct, Paul George, spent 14 years as a partner at KPMG (the focus of the investigation) is a clear example of a regulator that is too close to those who it regulates.\(^\text{18}\)

However, it is claimed that an FRC insider suggested the reason for their lax approach to investigating KPMG’s auditing of HBOS was because of a lack of resources\(^\text{19}\). This may seem like an easy excuse for incompetence, but the BIS wrote in 2011 that the UK Government would want the FRC to cut their costs\(^\text{20}\), which tallies with the claims of the FRC insider. When understood alongside the actual mechanics of the FRC, this is an incredibly worrying sign. If we accept that financial regulators usually lessen their vigilance as we move further away from the most recent financial downturn\(^\text{21}\) (for a number of reasons, including cost-cutting), then all of these factors mean that not only should the FRC not be considered for regulating the rating agencies, but radical reform is required for their regulation of the accounting industry. However, that analysis is for another day. For now, it will be useful to look at the next potential contender, the Prudential Regulation Authority.


\(^{20}\) *Id* 7.

The Prudential Regulation Authority

The Prudential Regulation Authority, which was formerly a subsidiary of the Bank of England but now, after the Bank of England and Financial Services Act 2016, is the Bank of England, was formed alongside the Financial Conduct Authority from the termination of the Financial Services Authority. It is the UK’s prudential regulator for deposit-taking institutions such as banks, building societies, and credit unions, as well as insurers and major investment firms and in so doing regulates around 1,700 firms. Its role, primarily, is to be concerned with the safety and soundness of the financial system, within which it provides for rules governing the internal management of a given financial institution; setting rules for insuring the levels of capital that a bank must hold in reserve, for example.

The PRA is perhaps the most straightforward regulator on our list. Although the PRA is not an obvious contender to be regulating the credit rating industry, as it is concerned with aspects such as interest rates and other similar things which have a direct impact upon the delicate balance of the national economy, there are two factors which suggest that it may be a stronger contender than first thought. Firstly, it must be recognised that the UK has had no experience of directly regulating the rating agencies, so the obligation apparently imposed upon the FCA is not as guaranteed as one may think. Secondly, the Bank of England states that its principal aim is to make sure ‘that the system runs smoothly and that people can trust financial institutions’; the notion of ‘trust’ is perhaps the most vital component to the future

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of rating agency regulation. Therefore, this notion of increasing the trust in financial institutions, combined with the centrality of the ratings of the agencies to the operations of the firms that the PRA regulates, means that there is potential for the PRA to take a central role in a new regulatory framework around the rating agencies. This would probably be best within a system that is imagined later in the article (with regards to a specialised Office), but before we analyse that it is important to ask whether there are any issues with the way in which the PRA regulates the 1,700 firms.

The most prominent criticism of the PRA has been with regards to its transparency. The best way to meet the Bank’s aims of encouraging trust in financial institutions is to have them, and its own regulation of those institutions, be as transparent as possible. Yet, the Treasury Select Committee is investigating a complaint about the PRA and its reluctance to reveal details about a particular bank’s level of capital buffers, which lead Sam Woods, the new head of the PRA, to state that he will ‘look again with an open mind’ into whether the PRA could, in general, be more transparent. However, the proposal offered at the end of this article may negate worries regarding the potential lack of transparency at the PRA (which, in reality, is not as big an issue as with other regulators). Before that however, we will now assess the favourite to be given the task of regulating the rating agencies, the Financial Conduct Authority.

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The Financial Conduct Authority

The Financial Conduct Authority was established in 2013 alongside the PRA, after the dissolution of the Financial Services Authority; legally speaking, the FCA is the same corporate body as the FSA (which was previously the Securities and Investment Board created in 1986)\(^{25}\). Whilst the PRA focuses on the overarching stability of the economy by way of intervening in the operations of deposit-taking firms, the FCA has a similar mandate albeit via a different focus. In what is a representative claim from the FCA, the Authority aims to ‘intervene early in wholesale markets to mitigate the risk of harm being transmitted to retail customers’. In line with the PRA’s mandate as discussed earlier, the FCA believes that ‘market efficiency, cleanliness and resilience is delivered through transparency, surveillance and the supervision of infrastructures, as well as their principal users’\(^{26}\). It is clear to see that the FCA and PRA are attempting to sing from the same hymn sheet, but the FCA focusses more on the ‘consumers’ interaction with the financial services rather than the PRA which focusses more on the interaction between the financial services and the economy as an ideal.

The FCA regulates a wide array of financial firms, ranging from Banks, Building Societies and Credit Unions (in a different capacity to the PRA), to consumer credit firms, financial advisors, and Wealth Fund Management Firms. Apart from regulating the wholesale financial services arena, the FCA is also responsible for regulating the listing process, recognising investment exchanges, and other trading platforms\(^{27}\). The FCA derives its powers from the


\(^{26}\) Financial Conduct Authority *Enhancing Market Integrity* (2016).

Financial Services and Markets Act 2000\(^{28}\) (as amended by the Financial Services Act 2012\(^{29}\) and in part by the recent Bank of England and Financial Services Act 2016\(^{30}\)). From that statutory instruction, the FCA must have regard to a number of important and interesting principles. They must have regard to: the differing degrees of risk involved in different kinds of investment; the differing degrees of experience and expertise that different consumers may have; the need that consumers may have for the timely provision of information; the general principle that consumers should take responsibility for their decision; and the general principle that those providing regulated financial services should be expected to provide customers with a level of care that is appropriate\(^{31}\). Additionally, the FCA makes clear that it defines a ‘consumer’ as: retail customers buying financial products or services such as mortgages or ISAs; retail investors in financial instruments (such as shares or bonds); and wholesale customers, such as regulated firms buying products or making investments, or issuers looking to raise capital\(^{32}\).

It is clear then from the mandate above, and the definition of a ‘consumer’, that the ratings of the agencies are central to the concerns of the FCA. Apart from aspects such as ‘retail customers’ (not directly anyway), the credit rating agencies play an important role in each realm that the FCA is tasked with regulating. Although retail investors are likely to depend on other measures (like yield rates and credit spreads) rather than just credit ratings, the ratings are available to retail investors (in one form or another)\(^{33}\) and provide another stream of


\(^{32}\) Id.

\(^{33}\) Credit ratings are not as available as we are usually led to believe, despite what some may say. For an analysis of this factor, which is an important when we consider the reverence attached to the availability of the ratings of
information and analysis that may affect their investment decision. Furthermore, wholesale customers rely heavily on the ratings of agencies, irrespective of the new regulatory movement to remove any reference to the ratings of agencies from official regulations, and issuers of debt are fundamentally tied to credit rating agencies ever since the early 1970s.

What this means is that the FCA is, arguably, ideally placed to regulate the agencies because it can, at once, manage the operations of the agencies and also review the effect of that upon the main users of the ratings.

However, as with the FRC and the PRA, there are issues with the FCA that need to be addressed. In terms of the regulatory approach of the FCA, there are two issues that stand out above all else. Firstly, the Treasury stated when discussing how the new FCA would operate that the Government believes that the FCA’s regulatory approach must be ‘pursued in a way which recognises not only the limitations of regulation, but also the potentially negative effects of excessive regulation on market efficiency and consumer choice’. This pro-market viewpoint is extraordinarily dangerous, as proven by the recent Financial Crisis, and is particularly disrespectful to those who have paid the price for the iniquities of the marketplace. Adopting this philosophical approach when regulating the credit rating agencies, if that does indeed become the case, will lead to financial crises again and again.

agencies, see Herwig P. Langohr & Patricia T. Langohr, The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They Are Relevant 173 (John Wiley & Sons 2010).

34 The Dodd-Frank Act made the removal of references to rating agencies central to its new approach to rating agencies, see The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 Pub. L. 111-203, H.R. 4173 s.939. With regards to companies still relying on the ratings, even after regulatory reliance was removed, see Robert J. Rhee, On Duopoly and Compensation Games in the Credit Rating Industry 108 Northwestern University Law Review 89 91 (2013) - Rhee discusses how shareholders often dictate the investment options available to their managers of their companies by restricting their investments to products that carry a AAA rating (for example).

35 Naciri explains that after the collapse of Penn Central, the agencies began to charge issuers to signal to investors that they could repay their debt, which was the birth of the issuer-pays system, see Ahmed Naciri, Credit Rating Governance: Global Credit Gatekeepers 16 (Routledge 2015).

The second concerning element with regards to the philosophical approach of the FCA is its penchant for encouraging competition. Although this is built into the Authority’s mandate, that fact alone may show why the FCA is not designed to regulate the rating agencies – therefore, potentially, leading us to conclude that either the FCA would need to be redesigned, or that the rating agencies would need to be regulated by another regulator (or in a specifically designed form). The FCA focus upon competition because in a number of fields competition can be a positive element and result in positive outcomes for the consumer. However, the global credit rating industry is what is known as a ‘natural oligopoly’, which essentially means that the productivity, accuracy, and general usefulness of the rating industry will decrease if competition is encouraged (there are also a number of barriers to increased competition within the industry i.e. reputational capital). This aspect alone may be the determining factor when it comes to regulating the industry.

There is another element that is particularly concerning. There have been complaints made against the FCA regarding their handling of official complaints against market actors. The Financial Complaints Commissioner is said to have personally seen ‘examples of an unwillingness to face up to shortcomings… and delays in dealing with “awkward cases”’. If the FCA takes the lead on regulating the rating agencies, it will receive complaints about their conduct; if they are considered to be ‘awkward cases’ and subsequently dealt with in an inappropriate fashion, the consequences of that could be severe.

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37 Financial Conduct Authority *Enhancing Market Integrity* (2016).
38 For a representative discussion of the rating industry as being a ‘natural oligopoly’ see David F. Tennant & Marlon R. Tracey, *Sovereign Debt and Credit Rating Bias* 54 (Palgrave Macmillan 2015).
40 *Id.*
These criticisms are valid and worrying. It is highly likely that the FCA will be given the task of regulating the rating agencies if that role is required in the post-brexit UK, which although seems rational has the potential to result in a flawed regulatory arrangement where flaws often result in massive financial catastrophes. Yet, as the current regulatory framework stands, it is the best option available. Whilst we cannot accurately predict what course of action may be taken, it is worthwhile discussing how that current framework may be adapted in order to accommodate the regulation of the rating agencies within it, without losing any efficiency or effectiveness. The article will now present a brief idea that may be appropriate if the UK regulatory framework is tasked with accommodating the direct regulation of the agencies.

“The Office of Credit Rating Agency Regulation”

It is unlikely that the UK Government would create a new regulator to regulate the credit rating industry. But, as we have seen above, the current framework has crucial flaws in that will no doubt be exploited by the rating agencies. Therefore, what is required, arguably, is another layer of protection. In adapting the ideas of the Dodd-Frank Act and Robert J Rhee, what is proposed here is a specially designated ‘Office of Credit Rating Agency Regulation’ that sits within one of the regulatory authorities discussed above.

In the US, section 932 of the Dodd-Frank Act established an Office of Credit Ratings within the Securities and Exchange Commission (SEC), with its mandate being to ‘promote accuracy in credit ratings issued by Nationally Recognised Statistical Rating Organisations
(NRSROs)… [and] to ensure that such ratings are not unduly influenced by conflicts of interest. Rhee suggests that if additional expertise or input is needed, the Office could be composed of ‘regulators, academics, and disinterested industry professionals who would be tasked with analysing performance and making recommendations as to the award of bonus, and could incorporate additional methods such as an industry survey of investors and other knowledgeable constituents. Whilst the idea of establishing an Office and then supplementing it with outside opinions is a good one, it does not go far enough (there are already concerns as to the sentiment afforded to the Office by the SEC). Firstly, it does not counteract the issues within the host regulator. Secondly, the range of input from the ‘outside’ needs to be much wider, so that the chances of the Office being ‘captured’ are reduced. Thirdly, the chain of command makes the establishing of the Office a naturally-limited exercise at best.

So, with that in mind, and progressing on the assumption that the FCA will be appointed to regulate the ratings industry, it is proposed here that a specialised Office be established within the FCA. However, rather than just being the focal point of the FCA’s regulation of the rating agencies, and reporting directly back to them, the Office would also be mandated to report to a Parliamentary Select Committee (presumably the Treasury Select Committee) twice every year, to report on the regulation of the agencies and the conduct of the FCA in regulating the agencies and supporting the Office in its mandate. In order for this chain of command to work, the Office would have to be chaired by someone who was not a member

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42 Id.
43 Darbellay and Partnoy note how the Office for Credit Ratings went unstaffed for 12 months, see Aline Darbellay & Frank Partnoy, Credit Rating Agencies and Regulatory Reform in Claire A. Hill, James L. Krusemark, Brett H McDonnell, & Solly Robbins, Research Handbook on the Economics of Corporate Law 280 (Edward Elgar Publishing 2012).
of staff within the FCA. In addition to this, the regulatory panel that would make up the
directorate of the Office would have to be mandatorily diverse in terms of background. For
example, there would be a limit on the representation of (a) established regulators and (b)
members of the economic profession (broadly defined). The reason for this is that the actions
of the major financial players before 2007/08 brought society to its knees and the general
public are continuing to pay for those iniquities. Financial Regulators and their philosophical
knowledge base, the economic discipline, cannot be allowed to reign supreme when it comes
to regulating such socially-vital entities. So, in that vein, the constitution of the regulatory
panel of the Office would have to consist of a regulatory representative, a legal expert, an
expert in the social effect of the economy (i.e. an economic sociologist), an economist, a
disinterested regulatory professional (possibly a retired regulator) and potentially a
representative from a non-profit credit rating agency (although there are a number of issues to
be discussed in relation to this)\(^\text{44}\). The constitution of the panel is not strictly defined, but
there must be an element of representing society when regulating the industry, rather than just
analysing them from an economic perspective; that has been tried and resulted in the largest
economic failure since the Great Depression.

This approach could work, although as with any proposal there are a multitude of concerns
that would have to be discussed. However, whilst a debate on that proposal would be
welcome, it is the debate on what may affect the UK Government’s regulatory approach
which is of a more pressing concern. Before the article concludes there will be a brief
discussion on just some of the factors that will have to be taken into account; how much
weight the Government will attach to these factors we cannot know, but it goes without

\(^{44}\) For more on the issue of non-profit rating endeavours see Daniel Cash, *The International Non-Profit Credit
saying that the survival and prosperity of the United Kingdom will be its primary concern – what this means for the regulation of financial entities, entities that proved themselves to be venal when the opportunity strikes, is a massive concern.

Factors

The transition away from the European Union provides the UK Government with a number of opportunities, but also brings with it a number of potential hazards. How it emerges from the separation will, arguably, set the tone for its development for a number of years to come. However, in order to speculate about what may happen in the UK’s short-, medium-, and long-term future, it is appropriate to discuss the factors that may affect the decisions that the UK’s leadership will be forced to take. Although there are many aspects that will affect the decisions that will be taken, two stand out as immediate concerns for the UK and its regulatory system.

The first of these concerns is the potential for the increase of ‘regulatory arbitrage’\textsuperscript{45}. Essentially, regulatory arbitrage is when an entity moves between regulatory systems to reduce the regulatory burden upon them; there are a number of issues that arise from this practice, with the most noticeable being the potential for increasing systemic risk\textsuperscript{46}. Yet, for our discussion, the pressures that come with regulatory arbitrage, for the regulator, can be extremely influential. Earlier we saw how it is thought that the invoking of Article 50 will

\textsuperscript{45} For a definition and discussion about regulatory arbitrage see Jeffrey Carmichael & Michael Pomerleano, \textit{The Development and Regulation of Non-bank Financial Institutions} 40 (World Bank Publications 2002).

\textsuperscript{46} Id.
result in the flight of the rating agencies to the EU in order to comply with the EU regulations; the knock-on effect, in terms of regulatory arbitrage, would be for the UK to weaken their regulatory approach towards the rating agencies in order to keep them operating, and contributing, within the UK. This is recognised as being the fertile ground for a ‘regulatory race-to-the-bottom’47; this potential has been widely recognised by expert onlookers (including rating agencies themselves)48. The effect of this race-to-the-bottom should be all too obvious, but one scholar, talking in general terms about regulatory arbitrage, captures the essence of the pressures that may face the U.K:

In the financial realm, regulators face pressure to relax regulations to discourage investors and financial institutions from shifting capital to less regulated markets. Capital flight can lower regulatory budgets, decrease their power by diminishing the firms and capital under their jurisdiction, and anger key constituents49.

The effects mentioned by Gerding are of direct importance to the considerations of the UK because of one particular aspect; the jewel in the crown – The City of London.

The second concern that, arguably, will weigh the heaviest upon the decision-makers in the UK is how best to protect and advance the City of London’s fortunes throughout the Brexit process. The reason for this is quite simple; the fortunes of the City of London, both literally and figuratively, are an accurate gauge of how the UK will fare in the coming years. The financial services sector is responsible for 9.6% of national output, with the professional services contributing a further 4.9%. The UK is currently the world’s largest exporter of

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financial services, ultimately generating a trade surplus of over £47bn in 2011 alone. As for the City of London itself, it is estimated to have contributed £35bn to the UK’s national output in 2012, whilst London as a whole contributed £10bn more to the exchequer than it drew out in public spending. What is clear is that the fortunes of the Country and the fortunes of the financial services sector, which is dominated by the City of London, are intrinsically intertwined. What this means then is that any decision the UK Government will take will be based on a consideration of what is best for the City. This is rational, of course, but has worrying connotations. If it is deemed that to protect and advance the City there must be conscious effort to be seen to be ‘open for business’, which translates to a moderating of the regulatory approach, then the effects upon society may be grave. The proximity, with regards to time elapsed, to the Financial Crisis results in a simple question: is society ready for another crisis? The answer to that, either way, is rather dispiriting.

Conclusion

This article aimed to assess the regulatory options available to the UK with respects to regulating the credit rating industry. There are a lot of unknowns, admittedly, which make an exercise like this academic; it is hardly a stretch to imagine the U.K. coming to an agreement with the EU to keep the financial regulatory system very similar to the arrangement that exists today. However, that should not discourage such endeavours. The aim was to assess the options and that has been done; there are some options available but only one stands out above the rest – the FCA. The Financial Conduct Authority stands out above the other regulators, but its conduct and composition leave a lot to be desired. With what will be a crucial task, the question marks that will hang over the FCA regulation of the agencies are

question marks that will have a direct effect upon society. With that being said, there are options available that will optimise the current framework and seek to protect investors, and most importantly the public.

The article ultimately proposed that a multi-disciplinary Office of Credit Rating Agency Regulation be established that would answer to the FCA and a Parliamentary Committee. The Office would operate in a different manner to the Office set-up in the US under the supervision of the SEC, because the attitude shown towards that idea has not been encouraging in the slightest. The idea as briefly presented here can work, but whether or not it would ever be adopted is another issue entirely.

That other issue is the factors that will affect the decisions taken by the UK Government when negotiating the UK’s secession from the European Union. There is no denying that there is very little chance of the UK Government prioritising forward-thinking, socially-responsible financial regulation at a time when they need to encourage the largest of firms to stay in the UK, and to encourage trade not to abandon the UK in the face of uncertainty. Unfortunately, this position of desperation will be capitalised upon, but by the very entities that brought society to its knees. The UK has a fantastic opportunity to design a specific regime for the regulation of credit rating agencies and protect the citizens of the UK from the culture that has eroded the ethics within the industry, but it is feared here that the pressures facing the UK as a response to the decision taken by the British electorate on June 23rd 2016

will be too much and the UK, in trying to preserve its global status, will sink ever deeper into the clutches of those that decimated society in 2007/08.
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