CHAPTER FIVE

Rating, Dating, and the Informal Regulation and the Formal Ordering of Financial Transactions: Securitisations and Credit Rating Agencies

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I. Introduction

The main thesis of this chapter is that within the process of the globalisation of capital the role of the state and its law has markedly diminished and that many of the supervisory duties undertaken by the state have been outsourced to private entities. Indeed we are seeing a twofold development occurring: on the one hand is the privatisation of law as evidenced by the rise of contract as the determining instrument of relationships; and on the other is the hybridisation of state regulatory activity where state agencies act in consort with private entities to accomplish a range of activities hitherto undertaken by the state. The pace of globalisation has forced these developments as the state has been unable to maintain its grip, both financially and intellectually, over the ever-increasing demands made on it by the community. Moreover, globalisation as a transnational dynamic has highlighted the stark limits of the state's power and authority in the global community.

I demonstrate the elements of the thesis through a study of securitisation in capital markets, focusing on the role of credit rating agencies as private/hybrid regulatory authorities. The chapter begins with a discussion of globalisation and the role of law. It then moves into a presentation of the structure of securitisation, showing how complex the process has become and how securitisation has become one of the dominant financial techniques in capital markets. I follow this with an explanation of the role of credit rating agencies in nurturing capital markets. And, finally, I examine some examples of malfeasance, especially Enron, in the securitisation process and some of the responses that Enron has prompted. A key part of this response is the attempt by the state and international agencies to co-opt the rating agencies into the formal regulatory process via Basel II[2] with a concomitant move

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2 BIS (2000).

Michael B. Likosky (ed.), *Privatising Development*, 147-171

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from prescriptive rule-making to a more risk-based approach.[3] In following this path I share the convictions of Knorr Cetina and Preda[4] that to know a field we must become conversant with its epistemic practices, the interior of the world we focus on. But more importantly, the argument that economic life is embedded within society is crucial to understanding law, economy, and society.[5] Both Weber[6] and Granovetter[7] have assured us that, contra the new institutionalists, eg, Williamson,[8] an individual's economic activity are not a thing sui generis but wholly implicated within ongoing social relations. We therefore must understand the social, legal, and economic spheres of activity.

II. Capital Markets, Law As A Competitive Market, And Global Regulation

During the last 30 years of the 20th century, capital has enjoyed a free rein throughout the globalising world economy. It has explored and exploited the mafia economy of the former Soviet Union, the caudillo economies of Latin America, and the statist economies of the far East. Capital has been massively successful in creating wealth, but it has never thought twice about abandoning its hosts when the first signs of trouble have emerged. Mature economies have managed to preserve their financial autonomy at the expense of the weaker, immature ones. The world-system, in Wallerstein's terms, has continuously played to the advantage of the stronger states who have enjoyed monopoly rewards. While the overriding ethos has been one of laissez-faire, the serial collapses of some of the world's biggest corporations—Enron, WorldCom, Tyco—have exposed the corruption at the core of those corporations. Regulation has adopted a light role, one that tinkers with the margins of suspect activity, one that must not impose burdensome costs on economic activity. Much of that regulatory activity was outsourced to private companies who acted as proxies for the state. Credit rating agencies, for example, have legitimated much of the capital accumulation of the last century.

Among the most important markets in modern commerce are capital markets, creating the links by which capital will be able to finance ventures. And the key to the success of capital markets has been role played by securitisation, the ability

[3] BIS (1999).

[4] Knorr Cetina and Preda (2001).

[5] Boettke and Storr (2002).

[6] Weber (1921).

[7] Granovetter (1985).

[8] Williamson (2000).

to raise large amounts of money while shifting the resultant debt off the balance sheet. Institutions have flocked to take advantage of this financial instrument being enamoured of the benefits securitisation will bring them and their shareholders. Securitisation is used by the largest, e.g., Enron, to the smallest companies. For example, in India microcredit, the lending of small amounts of money to many villagers, is securitised and backed not by assets but rather by first loss guarantees given by a charity.[9]

The combination of being the biggest markets for capital and finance and having adaptable legal rules has raised New York and London to a commercial premier league: they are members of a global hierarchy that have become 'global financial articulations'.[10] They exhibit their capabilities by having within their folds the largest investment banks and law firms handling the business of capital markets. Within the last 25 years of the 20th century capital markets work has soared at the expense of the decline of the industrial manufacturing economy, and has become dominated by a small number of players. The banks, international governmental organisations, law firms, consulting firms, accounting firms, regulators both formal and informal are found here. The presence of these institutions have created virtually insuperable obstacles to entry by other countries. No other country is able to match the critical mass of expertise, power and financial acumen exhibited by these two countries, or, more accurately, the cities of New York and London.[11]

Law has, however, played a minor role in this process of globalisation, never quite sure of its place, function, or raison d'être, but this is now open to question. What will the intersection of economy and law look like in the years to come? The answer at this moment is speculative; however, to prepare ourselves we must understand how we arrived at this point. I hope in this chapter to tease out some of the factors responsible for our condition. Despite the many international organisations that promote the rule of law in the global community, there isn't much law out there.[12] Most law, as such, belongs to local jurisdictions. Admittedly, there are UN Security Council Resolutions and the like, but their force is ambiguous:[13] the true force of the World Trade Organisation is yet unproven. There are also regional legal systems such as the European Community and the North American Free Trade Area that are gathering strength, but they are ultimately reliant on their constituent members' legal systems.

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[9] *The Economist* (2004).

[10] Friedmann (1986).

[11] Sassen (1991).

[12] Cf. Gessner and Budak (1998); Gessner, Appelbaum and Felstiner (2001); and *pace* Macaulay (1984).

[13] Cf. Wallerstein (2002).

How then is global business transacted? The answer is deceptively simple: it occurs through private ordering or contract. Why should this be so effective? Perhaps the solution to this puzzle is that virtually anything can be incorporated into a contract, especially private dispute resolution clauses that overcome the inbuilt prejudice to other national court systems. The malleability, adaptability, and creativity of contract has enabled the world to expand trade enormously since the second world war. Law is present—transacting in the shadow of the law—but is constructed on an ad hoc basis to meet the contingencies of specific transactions. Through repetition, these 'templates' acquire an iconic status that raises them above their particularistic locations and implants them into a global legal discourse that characterises them as 'virtual global law', e.g., the Maxwell Protocol as private treaty regulating UK Administration and US Chapter 11.[14] Global law, put crudely, is the sum of the legal/financial transactions in the world—a concatenation of micro events that fulfil macro-expectations and fears.[15] Law making in a globalised world has become decentred, disintermediated, and fragmented.[16]

In this sketch of legal globalisation there is one actor whose situation, rather like Sherlock Holmes' dog that didn't bark in the night,[17] is noticeable by its absence, that is, the state. The state adopts a different role in respect of global business transactions than it maintains in its local operation. In globalisation, states are reduced to positions equivalent to other more mundane actors; states cannot arrogate to themselves the power to reign over others;[18] or as Hobe puts it, 'international financial markets have emancipated themselves ... from any state control.'[19] The state's control function is/has shifted to other entities, chief among them the multinational corporation (MNC)[20] and also through regulatory agencies. MNCs take many guises and their behaviour often requires careful scrutiny to ascertain that they are not acting beyond their remit. Among the regulators who have oversight in some of these matters, some have yet to establish themselves such as the Financial Services Authority (FSA) in the UK, whereas others are certainly more powerful, such as the Securities and Exchange Commission (SEC) in the USA. Control and regulation are activities that are primarily administered within local jurisdictions and both the FSA and SEC concentrate mostly on their own turfs.

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[14] Flood and Skordaki (1997).

[15] Cf. McBarnet (2002).

[16] Teubner (1997).

[17] Conan Doyle (1960).

[18] Cf. Likosky (2002).

[19] Hobe (2002) p. 381.

[20] Muchlinski (1995).

Since the collapse of Enron in late 2001, however, the SEC has sought to transform itself into the global regulator through the Sarbanes-Oxley Act of 2002.[21] The types of tensions that are emerging are typified by the following example. Under the new rules any corporation wherever based with a listing on an American stock exchange must have the chief financial officer (CFO) or chief executive officer (CEO) certify the accuracy of the accounts. As one New York lawyer put it, 'The price for admission to the US markets will be to play by our rules'.[22] The SEC has clearly signalled its awareness that global competition in regulation will be determined by being the key entity that devises the rules of the game. Nor can those US-listed foreign corporations escape the grasp of the SEC by delisting from the American exchanges.

For those who fear the requirements are too extensive, delisting is no easy feat. Joseph McLaughlin, securities partner at Sidley Austin Brown & Wood said: 'Once you're here in the US, you're here for good.' It becomes especially hard to delist once a company has over 300 stock holders.[23]

One area where state law unwittingly introduces tensions is when regulatory schemes differ. This form of transnational regulatory capture creates difficult if not impossible situations for some international companies. For example, for German companies' CFOs or CEOs to perform their roles assigned under Sarbanes-Oxley would contradict German law because no single officer can be held accountable, only the board as a collective entity. The SEC response to this cultural difference has been that it is '"irrelevant" that under German law board members take "collective responsibility" ... [and that the] SEC will not be giving foreign issuers exemptions from requirements under the Act, and called local law differences just "details"'.[24]

One other illustration of how far globalisation has progressed may be given. It is the governing rules and norms of the major transactions in the world today. Most financial transactions, especially those relating to capital markets, are accomplished under the rubrics of English and/or New York state law.[25] This is not to say that other legal rules are not used, but their role is usually subsidiary to the two main sets of legal rules. Even the Lord Chancellor has noted the importance of English law in the international legal market:

> In our new leading role as co-ordinator and sponsor of the legal services market we are looking to increase the quality and competitiveness of British legal services in the domestic and global markets. We can do this in two ways: by

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[21] Sarbanes-Oxley is the United States' government's rapid response to the slew of scandalous corporate collapses that followed Enron's mega-bankruptcy in late 2001.

[22] *The Deal* (2004).

[23] Davidson (2002).

[24] Davidson (2002).

[25] Flood (2001; 2002).

> promoting legal services as a contributor to the national economy (not least in foreign earnings) and by providing legal support for the commercial world ... We will achieve our aim by working with the legal sector to increase the UK's market share in international legal business and thus contribute to the UK's economic performance. We are also working to reduce barriers to international trade in legal services; we encourage foreign market liberalisation; and we are promoting the UK as a global centre for dispute resolution and other legal services. This includes working through GATS (the General Agreement on Trade in Services) 2000 to reduce regulatory barriers to trade in legal services.[26]

The market for legal services is vigorous and extremely competitive: it needs to be kept at the forefront of consumers' minds as much as possible. The malleability and dexterity of American and English law helps them maintain their competitive edge.[27] A securitisation lawyer spoke of the dominance of Anglo-American modes of legal thought in this way:

> We're doing a deal in Italy and it has to be under Italian law. But it isn't as finance-friendly as English law, so we have to persuade the Italian lawyers to incorporate English thinking about financial matters into their Italian documentation. It looks Italian but it feels English and acts English.[28]

III. Securitisation

The means of providing access to capital adopted in the recent globalisation have been original, inventive, and profitable, innovation being stimulated by the returns to exports of financial and ancillary services, which are enormous.[29] A primary candidate for the distinction of being the most innovative of these techniques is

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[26] Lord Chancellor's Department (2002) p. A3.

[27] Lord Irvine has iterated this point in a recent article where he wrote, English contract law achieves its 'objective in two ways: by creating legal rules based on realistic trade customs, and by recognising that traders often wish to incorporate standard terms and practices into their agreements' (2001: 339). This makes an interesting contrast to Weber who saw English law as an exemplar of substantive rationality, not quite as sophisticated as the formal rationality of codified Continental law, which has proved less flexible than Anglo-American common law in adapting to the requirements of commercial modernity Weber (1921) and cf. Shamir (1993).

[28] Interview with securitisation lawyer, November 2002.

[29] Cf. Sassen (1998).

securitisation. It has granted corporations the potential to raise money, issue debt, and yet prevent the debt from appearing on their balance sheets.

What then is securitisation?

In their simplest form, asset securitisations involve a 'sale' of financial assets (such as trade or consumer accounts receivable) by the firm seeking to raise capital (the 'originator') to a separate, specially created corporation or trust (usually called a special purpose vehicle or SPV). The SPV raises the purchase price of the assets by selling debt or equity interests in public markets or through private placements. This series of transactions leaves the investors with claims against the SPV, the SPV with the assets transferred by the originator, and the originator with the proceeds of the sale transaction.[30]

Let me deconstruct this definition. In order to finance both domestic and international expansion, corporations have desperately sought alternative means of funding that do not entail bank lending, i.e., the process of disintermediation. If the corporation is a bad credit risk, no bank will want to lend, except perhaps at usurious rates of interest. Bank loans are in any case expensive and have the downside of often creating charges over corporations' assets that can have future deleterious consequences. Here is an illustration: if a large corporate encounters difficulties with cash flows, it has a number of choices—none of which are appealing. If the company goes through normal insolvency procedures, it may be transformed into something else entirely depending on its creditors' views.[31] This could be through, for example, an administration or a liquidation. Each is a death knell for the company. If the corporation is unburdened by charges—that is, there is 'flesh on the bone', as one banker has artfully phrased it[32]—the potential rescue remedies, for example, the London Approach,[33] may be less threatening and more facilitative. The future survivability of the corporation may in this way depend on the way money is borrowed.

Another reason for the growth in securitisation is that banks have been placed under increasing pressure to modulate their capital requirements. Regulators, in order to forestall financial crises, have coerced financial institutions into raising their capital adequacy requirements. If a bank has to maintain an eight percent capital ratio against loans on its balance sheet, its scope for future investment and action generally is limited, 'so removing the loans from the balance sheet through securitisation will reduce capital requirements'.[34]

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30 Frost (1997) p. 103.

31 Finch (2002). One question that arises here is: will foreign local jurisdictions with potentially antiquated insolvency laws give effect to English or New York law? The situation is not clear cut. News (1999) p. 6.

32 Flood (2001).

33 Flood (2001); Armour and Deakin (2001).

34 Baron (1996) p. 83.

Assets in securitisations can be of differing types: oil and gas; lease, car loan or credit card receivables; commercial mortgage loans; sovereign debt; equipment leases; state lottery winnings; litigation settlement payments; and royalties from record sales.[35] A recent securitisation involved the issuing of bonds based on the lease income of unfinished buildings at Canary Wharf.[36]

The final element in securitisations is the special purpose vehicle (SPV) that is to carry the investment risk attendant on issuing bonds. SPVs are legal entities created to carry the risk in a bankruptcy/insolvency remote fashion so that the if the originator succumbs to insolvency, the SPV and its investments remain out of harm's way. The SPV is known as an 'orphan' company and its permitted business activities are strictly limited.[37] The keys to successful securitisations are, firstly, carefully prepared documentation, which is normally drafted by large law firms. This sets up the transaction in a fool-proof manner allowing the participants to forestall virtually any crisis that might affect the life pattern of the securitisation. The second key is a high rating for the deal by one of the major credit rating agencies. During the structuring of the transaction the 'raters' see the drafts of the documentation and critique it so that it will fulfil their expectations and permit them to issue a triple A rating. Without either of these keys a securitisation is doomed to fail.

Ultimately, securitisations are about managing risk in periods of financial uncertainty, creating instant funding by selling future cash flows, and arranging finances to the best tax advantage. These needs compel the architects of securitisation onwards to more and more complex deals that disperse risk more efficaciously for the participants and remove the responsibility for action from the originating parties to new, artificial entities. The discourse of securitisation decentres the action in such a way that the participants' voices are transformed from active to passive. The twin moves of dispersion and diversification, especially as deals increase in complexity, in the financial markets create environments where the necessity to assume responsibility is diminished. Each actor in the process—lawyer, bank, or accountant—becomes a mere functionary not responsible for the entire transaction.

The following simple example of a securitisation by Danaharta, the Malaysian national asset management company, shows how the process works, represented diagrammatically in Figure 1.

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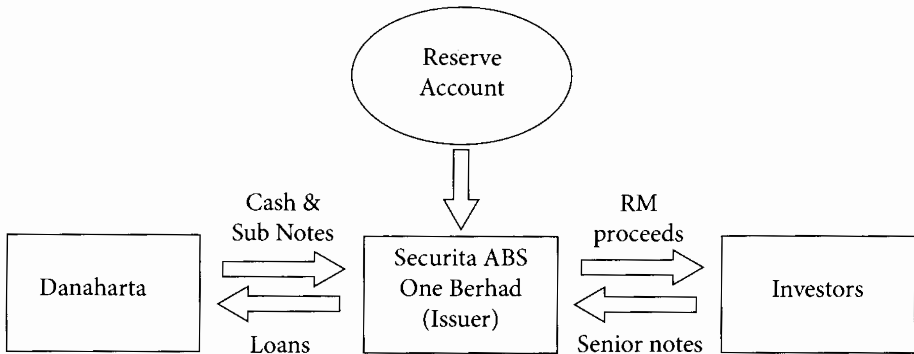
[35] Feldkamp (2001) pp. 546-547. David Bowie issued 'Bowie Bonds' in 1997, which were asset-based securities based on revenues from future sales of Bowie's early albums. Clark (1997) p. 50.

[36] Mannix (2001).

[37] Schwarcz (2002) p. 286.

Figure 1: Diagram of Danaharta Securitisation Process

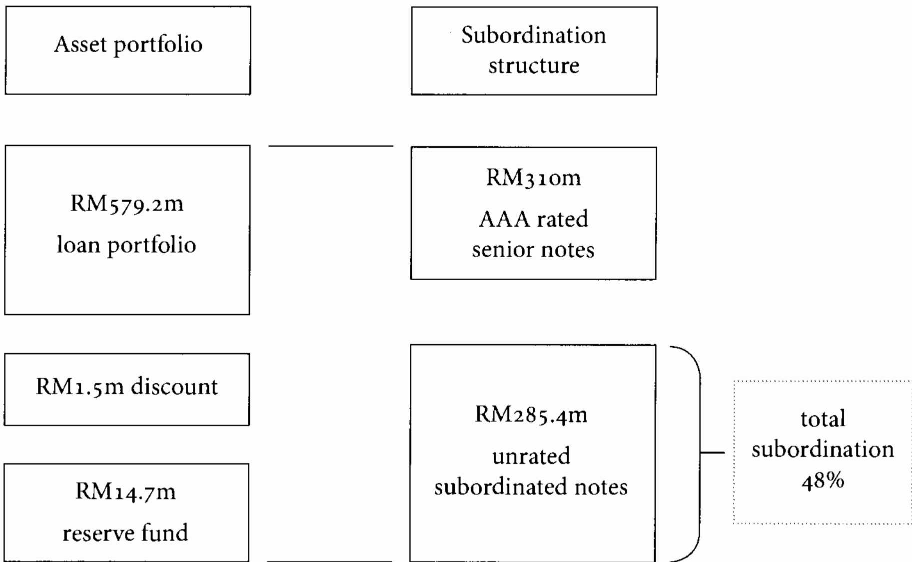


Key: Danaharta = originator
Securita ABS = SPV
Cash & Sub Notes = subordinated notes and cash
RM proceeds = cash
Berhad = rating agency

The securitisation pictured here is a collateralised loan obligations (CLO) transaction. This transaction essentially consisted of the transfer of a portfolio of performing loans and cash amounting to RM595 million (approximately £100 million) from Danaharta to Securita, the special purpose vehicle, in December 2001, one month after the proposed launch. In return Danaharta received cash and subordinated notes issued by Securita, the SPV. Securita raised the cash by issuing RM310 million (£52 million) worth of senior notes to the investors. These notes have a coupon rate of 3.875 per cent and they will mature in December 2005. The senior notes have to be redeemed before the subordinated notes can be redeemed. Danaharta also serviced the loans sold to Securita for a separate fee. The reserve account was established to cover any shortfall in coupon payment on the notes as well as expenses. The Malaysian rating agency, Malaysia Berhad, rated the senior notes 'AAA', the highest possible rating. And in order to provide 'comfort' to the senior note holders, the degree of subordination was extensive amounting to RM 285.4 million (£48 million) or 48 per cent of the total asset portfolio.[38] The asset portfolio is illustrated in Figure 2.

[38] Two points need to be emphasised here. First, the key investors must insulate themselves from intervening creditors by ring fencing the assets of the SPV. Second, SPVs are allowed to issue more than one class of security. In this case the junior classes always bear the first loss, but often in return for this the junior classes receive a higher rate of interest.

Figure 2: Structure of Danaharta asset portfolio and subordination structure



When the Danaharta CLO transaction was launched in November 2001 the senior notes were issued at close to face (par) value giving a yield of 4 per cent per annum. The offer was 3.5 times oversubscribed amounting to orders of RM1.0 billion (£168 million). The profile of the investors shows institutions were the key buyers with pension funds taking 16 per cent, investment funds taking 21 per cent, banks taking 19 per cent, other institutions taking the remainder.[39] These types of corporate bonds are more often than not bought by institutions rather than individuals.

The Danaharta example is a classically simple one, but investment bankers are continually searching for ways to create, as they phrase it, 'value' in the markets and increase liquidity, and securitisation has a basic malleability that allows it to be transformed into many shapes and guises that appear to be one thing but do another. Only the scope of the professional service providers' imaginations limits the form taken. The securitisation of Formula One motor racing skillfully demonstrates their artfulness.[40] Bernie Ecclestone, the owner of Formula One, announced in 1997 that he would float the company on the stock exchange. Investors were extremely wary

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[39] Danaharta (2002) pp. 39-40.

[40] Mannix (1999).

because they could not analyse the benefits and costs in 'normal' market ways. So the IPO launch was abandoned. Instead Morgan Stanley, with its lawyers, Clifford Chance, created a synthetic initial public offering (IPO) in which the issuer sold shares but the investors bought bonds.[41] This enabled the company to raise cheaper money in the debt market than in the equity market, but it looked as though the company was going for an IPO.

The key to the deal was that rather than sell shares in Formula One direct to investors the shares would be sold to a SPV which would then issue bonds. In total, the deal involved six different companies. The originator was a company called SLEC which owned Formula One Management. This company directed the Formula One business by selling rights to broadcast races to television companies; it also employed 200 people who ran the business.[42] There were two SPVs, Formula One Administration, which held the assets to be securitised, and Formula One Finance, which issued the bonds. The remaining companies were Formula One Licensing, which owned the trademarks of the business, and Formula One Holdings, which owned Formula One Administration.

The transaction was carried out as follows: SLEC sold its shares in Formula One Management to Formula One Administration. To pay for the shares, Formula One Administration borrowed USD 1.4 billion from Formula One Finance. Formula One Finance raised the USD 1.4 billion by selling Eurobonds backed by interest repayments on the loan. This money was then used to buy shares in Formula One Management from SLEC. The money stops at SLEC.[43] A typical securitisation would result in the money from the issue being used to buy the assets to be securitised, namely, the Formula One brand and the broadcasting contracts with the television companies.[44] Following the share purchase, Formula One Administration bought the assets from its own subsidiary, Formula One Management, for the book value of USD 15 million. It also set up a licensing agreement to secure the use of the Formula One trademark. Finally, SLEC sold its shares in Formula One Management for USD 1.25 billion, which gave it the non-recourse finance it desired. The Eurobond acts as a taster for a future IPO. A further advantage of the bond issue is that the

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41 Only the major law firms and investment banks do these transactions: they have very tight deadlines and require fast turnarounds on the documentation. Both Clifford Chance and Morgan Stanley are in the upper echelons of global professional service firms.

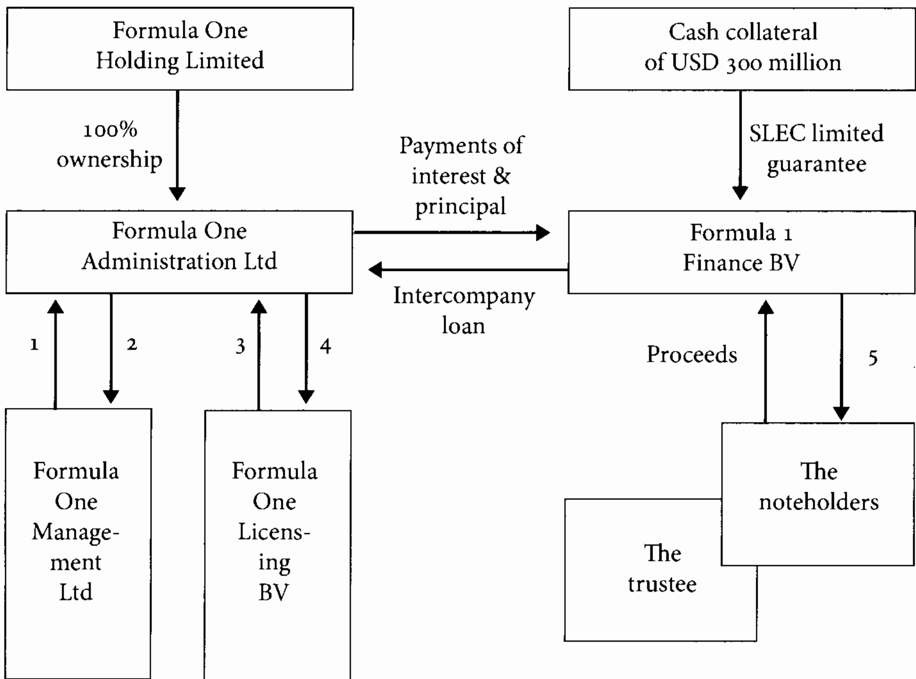
42 Mannix (1999) p. 12.

43 Mannix (1999) p. 13.

44 The assets of Formula One are as follows: the goodwill in Formula One motor racing; television contracts; promotion contracts; radio contracts; video contracts; viewing statistics; Digital Television Equipment; intellectual property rights; 1998 Concorde Agreement; FIA Agreement; swap agreement with Morgan Stanley; and a liquidity reserve of USD 100 million. Mannix (1999) p. 13.

disclosure requirements are not so stringent, so features of television contracts are kept secret from other television companies. Nevertheless, some disclosure is required. To avoid doing this the bonds are backed by the loan from Formula One Finance to Formula One Administration rather than the actual assets. The only requirement here is to disclose the details of the loan agreement and nothing more. Again this type of deal requires creative drafting from law firms like Clifford Chance who constantly work with investment banks on securitisations. And without the sanction of the credit rating agencies, i.e., a triple A rating, a deal of this sort could not come to market. This is especially important given that Formula One failed in its original intention of going for an IPO. Figure 3 outlines the Formula One deal.

Figure 3: The legal structure of the Formula One securitisation



Key: 1. management services
2. 100 per cent ownership and semi-annual fee
3. trade mark licence
4. share pledge
5. FRNs carrying the right to interest and principal

The relationship between the originator and the SPVs is clearly one-way, but the SPVs have an interdependent relationship that helps keep the assets and bonds in different boxes. In effect the SPVs become kinds of channels along which the funds flow.

Securitisation, then, is a vehicle that creatively permits companies to achieve a number of ends simultaneously, whether they be simple access to funds or a more calculated approach to the market that allows testing of the market for planned future long-term action. As the Formula One securitisation shows, securitisations are becoming increasingly intricate as SPVs are interposed among other SPVs. These securitisations have become known as 'conduit' securitisations because in them issuers and financiers attempt to prevent the sources of assets and other confidential information from entering the public domain.

Feldkamp plays artfully with the term securitisation when he suggests that:

> Securitisation can be magic. By creating riskless arbitrages and means to spread prepayment risks, collateralised mortgage obligations reduced the cost to fund US homes by perhaps a full percentage point in the 1980s. In the 1990s, securitisation opened the door for businesses by the hundreds to liquefy balance sheets, repay debt and avoid the calamitous effects a liquidity crisis can have on leveraged enterprises. In the process, securitisation became a cornerstone of America's reconstruction of basic financial market models.[45]

The benefits that securitisation brought to the economy of the late 20th century became plagued later by a pernicious complexity. We can compare securitisation to the Hummvee, a Swiss All-Terrain vehicle favoured by film stars such as Arnold Schwarzenegger.[46] It is enormous, it has gigantic ground clearance, and it is capable of running on flat tyres for miles.[47] In financial circles, the special purpose vehicle has become the equivalent of the Hummvee. It is usually big, it provides unbridgeable clearance from its originator's balance sheet, and, if it becomes insolvent, it won't damage its parent company. The late Enron was extremely fond of the special purpose vehicle as it enabled the company to inflate its profits by billions of dollars and simultaneously denude its balance sheets—a reprise of Gordon Gekko's 1980s 'Greed is good, greed is right, greed works' philosophy.[48] The confusion created by

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[45] Feldkamp (1999) p. 9.

[46] I am aware that I may be fetishising securitisation, but I think it's justified. Cf. Maurer (2002).

[47] swissatv.com (2002).

[48] *See* the movie *Wall Street* (1987; director: Oliver Stone; studio: 20th Century Fox) (<www.fast-rewind.com>). The character of Gordon Gekko, played by Michael Douglas, was allegedly based on Ivan Boesky, the convicted arbitrageur.

hybrids in securitisation, especially that of the credit derivatives market, has now led to a massive re-regulation of financial markets.

IV. Credit Rating Agencies

Without the sanction of the credit rating agencies, none of these transactions would be possible. Someone has to give his or her imprimatur to the deal. During the 20th century the raters have made this market their own—it is the fastest growing part of their business—since John Moody started his rating agency in 1909 when he rated railroad bonds.[49] Ebenroth and Dillon portray credit rating agencies in the following way:

> Rating agencies rate the spectrum from corporate public utilities and conglomerate or international corporations to municipal issuers and national governments as well as both foreign and US companies. But whether it is a rating on debt or securities or a course to improve or hold a rating which raters communicate, rating agencies take pains to say that they are not recommending any course of action to individuals and institutions which purchase their advice. Raters say further that the companies, issuers and investors who use their information do so at their own risk without a resulting duty of care on the part of the rater.[50]

Rating agency consumers are in a Catch-22: the raters apparently owe a duty of care to no one.[51] Despite the caveat emptor philosophy, consumers are keen to accept the determinations of the raters. The base norm for acceding to the raters' decisions is trust based on the reputational capital that the raters have built up over many years. The president of one of the big three raters, Standard & Poor's', characterised the service provided by his company thus: 'I believe the fundamental reason that Standard & Poor's and others' ratings have grown in importance in our capital markets is our long track record of providing independent, objective, and reliable opinions on creditworthiness....'.[52] Moody's president reiterated the point (though with a warning that Moody's ratings were not a 'guarantee' of performance.[53]

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[49] Sylla (2001) p. 2.

[50] Ebenroth and Dillon (1993) p. 174.

[51] Ebenroth and Dillon (1993) p. 176. Two American cases which largely absolve the raters of an extended duty of care, viz., First Equity Corp. v. Standard & Poor's Corp. (869 F. 2d 173) and Mallinckrodt Chemical Works v. Goldman, Sachs & Co. (420 F. Supp. 231 (SDNY 1976)).

[52] Standard & Poor's (2002).

[53] Moody's (2002).

According to Kuhner, 'for many financial market segments, evaluation by one of the great, internationally reputed agencies serves as an entry ticket.'[54]

The most recent count of rating agencies in the world produced about 74 agencies.[55] Essentially, however, there are only three agencies of global reach. They are Standard & Poor's (S&P), Moody's, and Fitch-IBCA. The ups and downs of the careers of these agencies shows that they prospered until the 1930s, but they then floundered until the 1970s, when the numbers of bonds exploded and the raters switched their market focus from retailing information to investors to providing services to the issuers of bonds.[56] This was an extremely clever move by the rating agencies as it meant they become involved in virtually every deal undertaken. As a result the raters have been successful at accumulating vast amounts of information on tens of thousands of companies.

The procedure raters use is straightforward. Teams of analysts examine the executives of firms about operations, finances, and management plans, and also sift all the documentary information required from the firm.[57] The determination process is carried out in secret committees and the raters do not describe their analysis. What raters do say is that their decisions do have a strong qualitative element requiring judgment.[58] Although the raters claim to be transparent, in fact their systems are opaque. In many cases secrecy is necessary, as when they rate the bonds in a securitisation.[59]

In a securitisation it is the issuer who pays the raters' fees, a cost which the issuer tries to recoup by paying lower returns on the debt issues. The higher the rating, the more secure the debt and the lower the rate of return. Most securitisations will fail unless they obtain the highest rating a rater can give. A high rating indicates a low risk of default. Moreover, the raters have oversight of the life of the SPV and can instigate a default if it fails to accord with the raters' standards for SPVs. But as Petrina Dawson, general counsel of Standard & Poor's has said, 'Financial engineers are trying to push the legal envelope with new asset classes, but the law is not keeping up with what they are trying to do.'[60]

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[54] Kuhner (2001) p. 2.

[55] DefaultRisk.com.

[56] Partnoy (1999) p. 653.

[57] Borrus (2002).

[58] Partnoy (1999) p. 651.

[59] Rating agencies are flat organisations with a high turnover of analysts because there is no effective career structure, unlike other financial institutions. They absorb vast numbers of graduates who are cheap to hire. In 1995 S&P employed 800 analysts and a total staff of 1200, and Moody's had 560 analysts and 1700 total staff. Partnoy (1999) p. 649.

[60] News (1999).

There are other twists in the raters' journey through a securitisation. Raters can insist on certain conditions in the transaction to strengthen bankruptcy remoteness or subordination. Moreover, the raters speak to all the parties to the deal, and this can have an interesting effect. If there is more than one rater involved in the deal and one particular rater insists on special conditions, the parties can talk to the other rater about its conditions. If they are less stringent than the other, then the two raters are played off against each other until the effects of the required conditions are neutralised.[61] This game aspect—i.e., rate shopping—helps to raise the subjective element in rating.[62] Raters also often have access to information denied to analysts and investors. The SEC exempted companies from revealing sensitive information only to bond raters. It could be client lists or profits on particular business lines.[63]

How do the ratings work? Table 1 shows the symbols used by the raters and their interpretation. Those above the median are acceptable risks but those below it are effectively 'junk'.

For users the key question is to what extent the ratings are reliable? The agencies argue they do the best they can, but the Economist remarked that:

> In 1997 two-thirds of debt rated BBB by S&P was priced within 20 basis points (hundredths of a percentage point) of the average bond with the same rating. Since then, the range has widened. Last year credit spreads' standard deviation, a measure of dispersion, had risen more than sixfold (*The Economist* 2002: 83).

The main arguments put forward for the credibility of raters are that they would lose their reputational capital if they put out false ratings despite any increase in fees. Ratings are expensive and presumably those who pay for them value them as a means of overcoming information asymmetries in markets.[64] One peculiarity of securitisation rating is that companies' special purpose vehicles can achieve credit ratings in cross-border securitisations above the sovereign ratings of their countries.[65] Perhaps the strongest argument is that raters do an enormous amount of business in their field:

> Moody's rates 20,000 public and private issuers in the U.S., and about 1,200 non-U.S. issuers, both corporations and sovereign states; S&P rates slightly fewer in each category. Moody's rates $5 trillion worth of securities; S&P rates

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[61] Interview with finance lawyer (March 2002).

[62] *The Economist* (2001) p. 110.

[63] Borrus (2002).

[64] Partnoy (1999) p. 633.

[65] Partnoy (1999) p. 667.

Table 1: Moody's and Standard & Poor's ratings

Moody's	*S&P*	*Meaning*	*Grade*
Aaa	AAA	Highest quality	
Aa1	AA+	High quality	
Aa2	AA		
Aa3	AA-		
A1	A+	Strong payment capacity	
A2	A		
A3	A-		
Baa1	BBB+	Adequate payment capacity	
Baa2	BBB		
Baa3	BBB-		Investment grade
Ba1	BB+	Likely to repay; ongoing uncertainty	Speculative grade, non-investment grade
Ba2	BB		
Ba3	BB-		
B1	B+	High risk obligations	
B2	B		
B3	B-		
	CCC+	Vulnerable to default; or in default	
Caa	CCC		
	CCC-		
Ca	C	In bankruptcy, or default	
	D		

$2 trillion. Moody's and S&P thus dominate the world business of rating government and corporate debt.[66]

The raters have taken, however, a considerable battering over allegations that they had not recognised the danger signals in the collapse of the emerging markets in Asia and Latin America, nor had they acted swiftly enough when Enron and its kin began their slides.[67] Even the International Monetary Fund has criticised the raters for their initial lack of response followed by overreaction in the Asian crisis of 1997.[68] In addition to these lapses investors became aware over time that the non-investment-grade bonds had been systematically mispriced, i.e., their record of default was less than expected, which should have not been possible with the raters' methodologies. This gave rise to the junk bond movement with Michael Milken at its helm as a means of mounting hostile takeovers.[69]

V. The Implosion of Securitisation—Ecce Enron

The securitisation market and the credit rating agencies have coexisted peacefully for many years. But, as Feldkamp mentioned above, the securitisation market has become increasingly complex and this has created tensions for players and investors alike. In 1999, he speculated that given 'the US securitisation market is mature, generally stable and rather predictable [it] probably means one group or another will now try to rig the market for their own benefit, by asserting competitive unfairness'.[70] The first years of the 21st century have lived up (or down) to Feldkamp's expectations, and have been turbulent for markets and raters. The collapse of Enron and the subsequent bankruptcies of WorldCom and Tyco, with the annihilation of Andersen, one of the Big Five accounting firms, have created turmoil for the markets and, indeed, governments.

Enron is the classic example of how the securitisation market was spun out of control. The central player in this drama is the credit derivative. It takes many forms, some of the most usual are credit swaps, credit options, and 'catastrophe

[66] Partnoy (1999) p. 650.

[67] Borrus (2002).

[68] *Financial Times* (1999). *See also* 'Japan's Downgrading Fans Criticism of U.S. Rating Agencies' (19 August 1999) and *Miami Herald* (26 September 1998).

[69] Partnoy (1999) p. 663. The junk bond, or high yield bond, promises the hope of dramatically high returns but at considerable risk. It enjoys marked popularity despite Milken's misuse.

[70] Feldkamp (1999) pp. 9-10.

bonds'.[71] The market for credit derivatives has been one of the fastest growing, as PricewaterhouseCoopers described:

> The credit derivatives market has grown from just over $200 billion in notional value in 1997 to $1.6 trillion this year [2002]. This market includes participants that are investment and commercial banks, insurance companies, corporate and hedge funds, with products ranging from single name credit default swaps to complex instruments, such as synthetic collateralised debt obligations.[72]

A market that can grow from USD 200 billion to USD 1.6 trillion in five years is one that needs rigorous scrutiny. Not only was scrutiny avoided, but the main players, including Enron, assiduously lobbied the Congress to ensure oversight was kept to a minimum.[73] The credit derivative is a hedge against a future event occurring, a form of insurance, in which the future event can be virtually anything from bankruptcy, to changes in foreign exchange rates, to a change in the weather. A pays B to assume the risk in exchange for a fee—all very simple, almost. Once the players start hedging on currencies, interest rate swaps, options (puts and calls), the potential for things to go awry is open because players can leverage their funds in ways that spectacularly escalates their exposure. In credit options, one tactic is to buy and sell options on the credit spreads of emerging market bonds.[74] As Partnoy puts it: 'Such options allow the investor to bet on the credit quality of a particular issuer without having to take a view on specific market conditions, such as interest rates ... a credit option, like a credit swap, may be a way for an investor who otherwise is not permitted, either by investment guidelines or law, to take a particular type of credit exposure, nevertheless to take such exposure through a credit option'.

In 1997, 'derivatives contracts represented more than USD 25 trillion in real assets' in the marketplace.[75] And Enron, according to Standard & Poor's, has thrown at least USD 3 billion worth of credit derivatives contracts 'into limbo'.[76] Because Enron was not a bank, it escaped SEC supervision. Enron began its foray into the financial markets with energy derivatives in 1993, which were designed to stabilise energy prices. To do this Enron persuaded the Commodities Futures Trading Commission to grant it exemptions in this area of trading. Enron then

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[71] Partnoy (1999) pp. 674-680.

[72] <pwcglobal.com> (2002). DefaultRisk.com lists about 30 research papers on modelling risk in and valuing credit derivatives.

[73] Cave (2002).

[74] Partnoy (1999) pp. 677-78.

[75] Cave (2002) p. 3.

[76] Cave (2002) p. 1.

took the credit derivative idea further by trading in 'weather derivatives'—'in which contracts on energy supplies would be dependent on bets as to whether the weather was hot or cold'.[77] By 2000, Enron had derivative-related liabilities of USD 10.5 billion. Much of this trading in derivatives was carried out through off-balance sheet financing with special purpose vehicles. Where then were the credit rating agencies during this roller-coaster ride in the derivatives market?

The raters were present because they were rating Enron's bonds, most of which was rated investment-grade. But they did not detect the slide until too late. Their excuse is that Enron fed them misleading and inadequate information, especially in relation to its SPVs.[78] In October 2001, Enron broadcast an equity of USD 2.2 billion which caused the raters to lower their ratings, but Enron was kept above junk bond status, i.e., above the median in table 1.[79] When Enron was not acquired by Dynegy a month later, a prerequisite for an investment grade rating, it was downgraded to junk status. And on December 2, Enron filed for bankruptcy. By that time the damage to investors and employees alike was done; only the senior management escaped unscathed with substantial exit bonuses.

A singular advantage enjoyed by the big three raters is the status of being 'Nationally Recognised Statistical Rating Organisations' (NRSROs).[80] This designation was granted by the SEC in 1975 to assist with the net capital rule which required broker-dealers to deduct percentages of the market value ('haircuts') of their positions to provide a safety net. If the securities in question had been rated investment grade by a credit rating agency, then the haircut would be smaller. To satisfy the criteria the raters had to be nationally recognised. The big three fitted the criteria in 1975 and, though others were later admitted to the designation, the number of NRSROs remained at three because of mergers. This gave a substantial fillip to the activities of the raters as it meant they were able to sell 'regulatory licences' to their customers, which saved them substantial costs. Many commentators have criticised the SEC for granting monopoly powers to a small, anti-competitive group of firms, but it appears the SEC will retain them or even possibly extend them.[81] While it appears that the raters have acquired quasi-regulatory powers, they insist on maintaining their independence from government.

Despite the raters' desire to remain apart from formal regulation, there are moves to incorporate them into the formal apparatus of regulation. The Basel Committee

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[77] Cave (2002) p. 3.

[78] Enron's SPVs were named after characters from Steven Spielberg's movies. Names included Chewbaca and Raptor.

[79] Borrus (2002).

[80] Hunt (2002) p. 1

[81] Hunt (2002).

for Banking Supervision in its Basel II proposals has put forward the idea that the raters' determinations should be incorporated as part of the process of creating a standard approach to credit risk in deciding how much capital banks should put aside for each loan.[82]

By advantageous manipulation of economic crises, the credit rating agencies are becoming imbricated in the regulation of the financial system. Their role has moved from being purveyor of information to being monitor of financial probity. Within certain limits, they have been successful, but those limits have to be drawn quite tightly. The raters do make mistakes, as Asia and Enron show. Finally, we have Sarbanes-Oxley, whose ramifications are just only being felt.

VI. Conclusion

Without doubt, securitisation will continue: it is too far embedded in the economy to be disregarded or disposed of and it is still gaining momentum. It may be regulated more subtlely if the regulators can develop the criteria to allow that. The credit rating agencies will persist because there is no one yet able to take over or extend their role. Even government and intergovernmental agencies want to incorporate them into the formal system of regulation. Both are part of the knowledge society. Knorr Cetina and Preda make a strong point when they argue the reality of economic activities:

> is no longer simply the 'natural reality out there' as interpreted within the frame of reference of personal experience and social conventions. Rather, it is a reality purposefully assembled and unfolded by professional knowledge workers and whole technological systems which provide the frames of reference and the means for experience and transactions to take place...understanding knowledge societies in terms of a technologically propelled economic dynamic must be supplemented by an empirically based understanding of how economic transactions are themselves penetrated and transformed by epistemic practices.[83]

This is where we are in the study of markets and their rule-making. I have only begun to show what is at issue. We know little of the dramatis personae and what we know tends to arise from problems and crises in the field rather than its quotidian concerns. If law is to become integrated in a facilitative yet responsive way into this field, we need to examine it far more closely, its activities, its knowledge bases, the actors. The world of securitisation and its agents is complex, even baffling, secretive, often the activity of the elite, but it has an enormous impact on us all.

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82 Danielsson et al. (2001).

83 Knorr Cetina and Preda (2001) pp. 30-31.

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