CHAPTER 3

Reliance Versus Influence: A Roadmap toward the Risk of Over-reliance

Introduction

When credit ratings were first introduced into US banking regulation in the 1930s and then into the Net Capital Rule of the 1970s, the aim was to prevent speculative investments that are too risky. On both occasions, regulators intervened in times of financial and economic crisis in which investors suffered significant losses consequent to excessively risky investments.144 Importantly, regulators noticed that the certification service provided through CRAs' investment grade threshold could work as a viable tool to cap the amount of risk that investors and market participants could take on. As analysed in Chapter 2, this explains why the private and public sector place considerable reliance on credit ratings. Clearly, regulatory reliance on credit ratings means the trust that the regulators put on credit ratings as instruments that can help fulfil the financial regulation's objective to limit risk and promote efficiency in the financial markets.

Nonetheless, regulatory reliance on credit ratings started to be questioned in the aftermath of the 2007–2009 financial crisis. CRAs have been regarded as one of the culprits of the recent financial turmoil.145 In a nutshell, CRAs were accused of: (1) inflating the ratings assigned to some structured products such

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as residential mortgage-backed securities (RMBSs) and collateralised debt obligations (CDOs) because of conflict of interest with the issuers (2) having inadequate rating methodologies and models for assessing the risk inherent to such complex products and (3) being slow in downgrading them promptly.\textsuperscript{146} As a result, the rating sector was subjected to close scrutiny at the national, international and regional levels.

The tie between credit ratings and legislation was under discussion as well. In this context, it can be observed that the events of the crisis radically changed regulator approaches to credit ratings. A new language has been adopted to describe the role of the ratings within financial legislation. The ‘hardwiring’ of credit ratings into legislation and regulatory frameworks is the new watchword that academics, regulators and policymakers use in the current debate on the role of credit ratings in legislation.\textsuperscript{147} Undoubtedly, this word has a negative connotation as opposed to the more neutral term ‘regulatory use of ratings’, which was mainly used before the 2007–2009 financial crisis. Regulatory use of ratings can be interpreted as referring to the credit ratings as essential parts of a regulatory programme. This is consistent with the concept of regulatory reliance illustrated above, namely the trust that regulators and policymakers put on credit ratings for achieving the goals of protecting investors from excessive risk and preserve financial stability.

On the other hand, the ‘hardwiring’ of ratings into legislation connotes the tie between credit ratings and legislation as dangerous. In other words, through this expression regulators and policymakers cast doubt on the utility of including credit ratings into legislation.\textsuperscript{148} This raises the question of why credit ratings, from essential elements of financial legislation, have now become regarded as intrusive and dangerous. This question can be answered by turning to the other side of the coin. In the previous chapter, attention was devoted to the utility of credit ratings and why they are widely used in the private and public sector (‘the good’). The analysis underlined the positive aspects of credit ratings in relation to the reduction of asymmetric information and transaction costs. Also, it highlighted how credit ratings convey information in

