An Analysis of the Competitive Situation on the EU Rating Market in Context of Regulatory Requirements

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Abstract

The market for external ratings is dominated worldwide as well as in the European Union (EU) by three major credit rating agencies (CRAs). These "Big Three" are Standard & Poor's (S&P), Moody's and Fitch Ratings. Due to the oligopolistic market structure and possible involvement in the 2008 financial crisis, the rating agencies have constantly come under criticism. This was associated with stricter regulatory requirements to ease the situation. The EU-Regulation on credit rating agencies („CRA-Regulation") coming into force 2009 and its amendments in 2011 and in 2013 have mainly governed such regulation. The aim of the article is to analyse potential regulatory impact on the still inherent oligopolistic situation on the EU rating market in the context of the CRA-Regulation. Selected key figures are used to observe over a defined period of time if and how the dominance has changed. The motivation for this article is the observation, that political and private efforts to establish a European rating agency as a counterweight to the three major agencies and other approaches to increase competition in the rating market, followed, which has not been resounding to date. In summary, it is shown that new agencies have a potential impact on the EU rating market and that the three major rating agencies still dominate the market but within a changed environment.

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Introduction

The market for external ratings is mainly dominated worldwide by the three major rating agencies Standard & Poor's (S&P), Moody's and Fitch Ratings („Big Three"); all three with U.S. principal owners. The term "Big Three" in this context refers to the rating agencies Standard & Poors, Moody's and Fitch Ratings. With their ratings, they provide relevant information in the financial sector about the risk of default of financial instruments in the area of debt capital and assess the ability of issuers to be able to meet future payment obligations in full and on time. Ratings are considered a recognized opinion in financial investment transactions. Ratings make it easier for issuers to access debt capital markets (Brieger, 2012). The importance of ratings has already increased in the 1970s. In capital market regulation, they had become increasingly part of regulatory rules, which strengthened the position of the Big Three (Brieger, 2012). The rating agencies were assigned a virtually institutional role, in particular due to the regulation on capital regulation within the framework of Basel II (Basel Committee on Banking Supervision, 2004) and the associated use of external ratings (Beck & Wienert, 2010; Brieger, 2012). In connection with the 2008 financial crisis, the rating agencies and their ex post incorrect assessments within an oligopolistic market structure came under increasing criticism (Blaurock, 2012; Deipenbrock, 2010). European legislators reacted to this with the EU Rating Regulation that came into force in 2009; amendments were made in 2011 and 2013 (Blaurock, 2013; EU Commision, 2009, 2011, 2013).

Based on the regulatory efforts and the associated intent to increase competition on the one hand and reduce the dependence on external ratings on the other, this article analyses the competitive situation on the rating market. Selected key figures are used to check whether the market structure has changed over a specified period of time. Associated with this is the question of whether regulation has brought about a change in the oligopolistic market structure.

The following chapter starts by explaining the development of the oligopolistic market structure with the major dominance of the Big Three. The empirical analysis shows the market situation over time. Then, in the next chapter, potential competitive alternatives on the rating market are discussed. The conclusion summarizes the essential findings and provides an outlook on further research needs in this subject area.

The oligopolistic market structure

An important aspect for the reasons of the market structure lies in the regulatory institutionalization of ratings for the financial markets. For the first time in 1936, the US "Controller of the Currency" stipulated that the purchase of securities that are largely speculative and do not meet a certain standard is prohibited. The governing body did not publish a more detailed definition, but referred in a footnote to the fact that the terms used can be found in recognized rating agencies' manuals (Harold, 1938).

Much later, in 1975, the the recognition as U.S. Nationally Recognized Statistical Rating Organization (NRSRO) was awarded for the first time by the U.S. supervisory authority Securities and Exchange Commission (SEC). Consequently, only ratings of companies with NRSRO status could be used to determine banks' capital requirements. In this context, the SEC directly determined the agencies S&P, Moody's and Fitch Ratings (U.S. Securities and Exchange Commission, 2005). The basis of the market-dominant position was thus laid for regulatory purposes. Since 1975, for over 25 years, until February 2003, the SEC has granted NRSRO status to four other agencies, which, however, had been merged or been taken over (U.S. Securities and Exchange Commission, 2003). Accordingly, only three large NRSROs existed sustainably until then. At this time Dominion Bond Ratings Service (DBRS) (February 2003) and A.M. Best Company, Inc. (March 2005) became other agencies recognized as NRSROs by the SEC and entered the market of regulatory recognized agencies (Langohr & Langhorn, 2008). Currently nine rating agencies are registered as NRSROs (U.S. Securities and Exchange Commission, 2020). With the so-called "Credit Rating Agency Reform Act" (United States Congress, 2006), enacted in 2006, rating agencies were able to register with the US Register SEC as a "Nationally Recognized Statistical Rating Organization" (NRSRO) instead of being nominated. The law made it possible for smaller rating agencies to register under certain conditions, opening the market to a larger number of rating agencies.

The EU Rating Regulation (EU Commision, 2009) entered into force at European Union (EU) level in 2009. The aim of the regulation is to ensure a high level of consumer and investor protection by applying common quality requirements for ratings given within the EU. The regulation also stipulates that a rating agency must apply for registration in order to be recognized as an external rating agency (External Credit Assessment Institution (ECAI)). Thus, the status as ECAI represents the European counterpart to the NRSRO of the U.S. SEC. The European Securities and Markets Authority (ESMA) (Regulation (EU) No 1095/2010), established on January 01, 2011, has powers over credit rating agencies with regards to registration and ongoing supervision. The admission requirements and the associated necessary information for the registration of rating agencies can be seen as an obstacle to entering the rating market. Newly established rating agencies are particularly affected because they do not yet have sufficient experience and the necessary organizational requirements. However, the regulation for the registration of rating agencies enables exemption from certain information details or requirements. In view of the demand for more competition on the rating market, high entry barriers for start-ups should be avoided (EU Commision, 2012).

A second important aspect for the existence of the oligopolistic market structure is that the effectiveness of ratings can only be observed ex post. Consequently, taking the rating into account when regulating or making investment decisions are made, requires trust in the analysis of solvency. This trust can be acquired by the agencies through many years of experience, the use of statistically valid methods and correct credit ratings in the past (Haar, 2009). This results in a reputation for the quality of the rating, which is crucial for the success of the agencies. The historical development and the aspect of reputation illustrate the difficult successful market access of new rating agencies and their establishment in the market. Once an issuer has decided on obtaining a rating from an agency with a corresponding reputation, any change in agency or unsubscribing is potentially questioned by investors. The assumption may be made that a possible "downgrading" should be avoided. This will force a concentration effect on the rating market (Lerch, 2010).

Empirical analysis

With the EU Rating Regulation of 2009 and its amendments in 2011 and 2013, numerous objectives and sub-objectives are being pursued. High consumer and investor protection, the promotion of competition, independence from rating agencies, the excessive use of ratings by market participants and a regular rotation of rating agencies are to be cited. In particular, the 2013 amendment aims to strengthen competition between rating agencies and to encourage the use of smaller ones. For example, in accordance with Article 8c of the current EU Rating Regulation for Structured Financial Products (SFI), issuers are required to request double ratings in order to guarantee a second, independent rating (EU Commision, 2013). Article 8d also determines the method of selection when mandating rating agencies for SFI. Consequently, if an issuer commissions at least two rating agencies to issue a rating for the same structured financial product, one of the two commissioned rating agencies may have a maximum market share of 10 percent (EU Commision, 2013). A structured financial product is a financial product "that consists of one or several baseline values and a derivative component" (Bundesanstalt für Finanzdienstleistungsaufsicht - Federal Financial Supervisory Authority, 2014). Traditional financial products such as corporate bonds are therefore exempt from this double rating (agency) requirement. The SFI market segment, is the second largest contributor to revenues at Moody's, after the corporate finance segment (Moody's, 2019).

These regulatory measures at EU level clarify, among other things: Efforts to increase competition on the rating market or to reduce the dominance of the three major rating agencies. From this, the research question can be derived whether the EU regulatory provisions have an effect on the oligopolistic market structure of the rating market and the market shares of the Big Three.

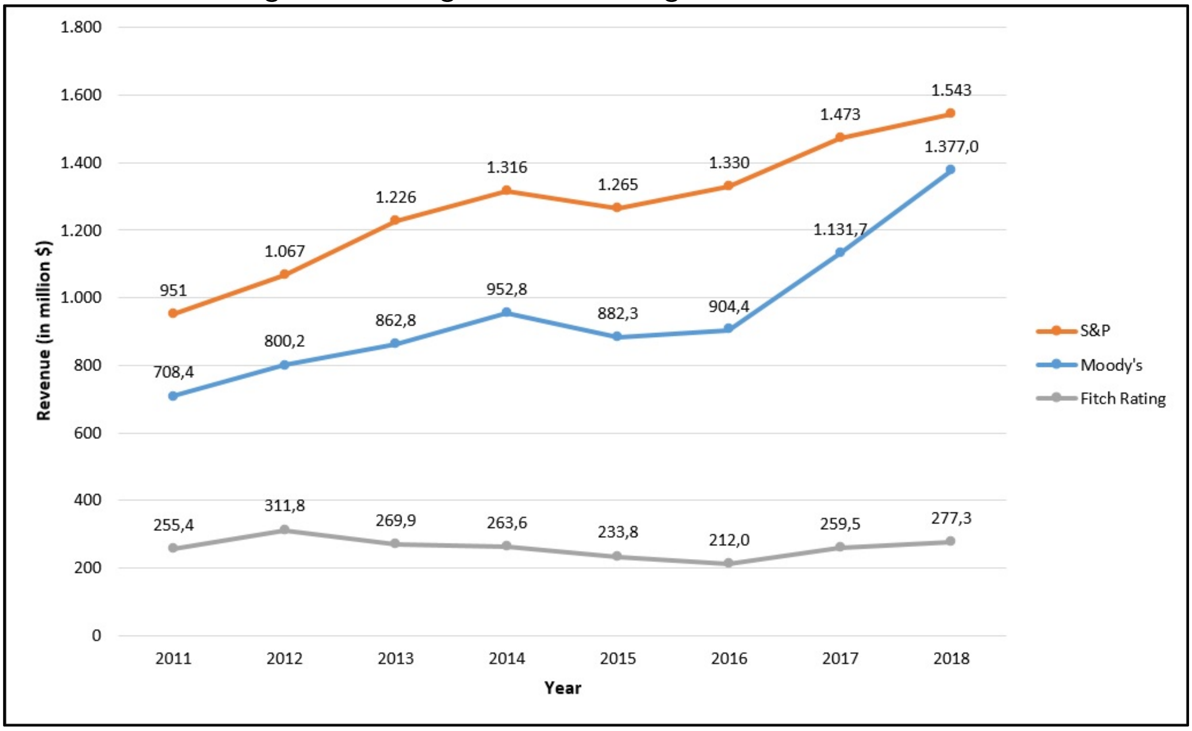
The following hypothesis can be derived on the basis of the research question:

- *Since the EU Rating Regulation came into force, the market shares of the three major rating agencies and the oligopolistic market structure of the rating market in the EU have remained unchanged.*

The research hypothesis aims to analyse the dominance or the oligopolistic market structure of the rating market at the level of the EU. To test the hypothesis, key figures from the overall rating market and the three major rating agencies are determined over a certain period of time. The time series analysis represents amongst other things the revenues of the Big Three on the EU market. The market share of the respective rating agency is also shown over time. The analysis relates to the rating agencies registered by ESMA to operate on accredited regulatory status within the EU. The results of the analysis can be used to validate or refute the hypothesis. First, the revenues of the Big Three are presented.

The data in Figure 1 essentially show a continuous increase in revenues over the observation period. S&P and Moody's in particular have been able to significantly increase their revenues in recent years. FitchRatings remains at a constant level. With these data, however, it should be noted that the European market for the three major rating agencies is not consistently restricted in terms of revenues in the respective annual reports. S&P reports the revenue for the European region, whereas Moody's reports the revenue of the EMEA (Europe, Middle East, Africa) economic area. FitchRatings, on the other hand, refers to its registered rating agencies in the EU when listing revenues (McGraw Hill Financial & S&P Global, 2014-2019); Moody's, 2014-2019; FitchRatings, 2013-2020). The agency publishes the so-called EU Transparency Report since 2012 for the financial year 2011. Moody's (from 2010) and S&P (from 2015) also publish such a report, which is likewise a basis for assessing the market situation (market shares) in the EU and confirms the authors' argumentation and hypothesis (McGraw Hill Financial & S&P Global, 2016-2020; Moody's, 2011-2020). A trend is discernible.

Figure 1
Revenues of the Big Three in segments including the EU 2011-2018



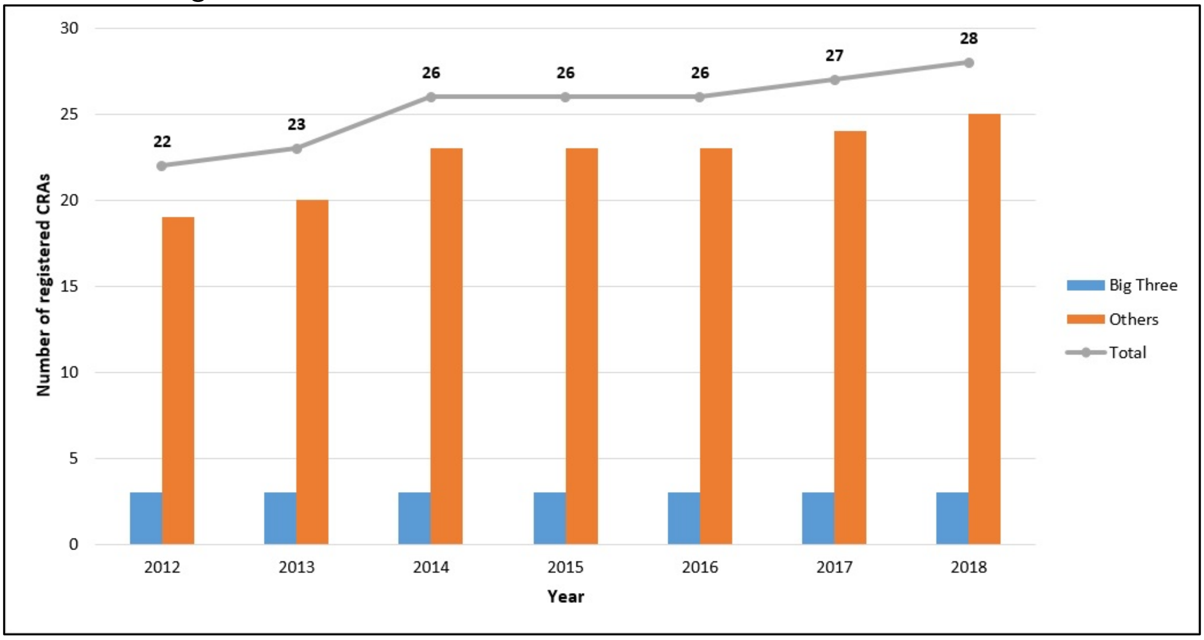
Source: McGraw Hill Financial & S&P Global (2014-2019); Moody's (2014-2019), FitchRatings (2013-2020)

Another key figure that reflects the competitive situation of the rating market in the EU is the number of rating agencies registered by ESMA. As ESMA only started its work on January 1, 2011, the data published by the institution will only be available from 2012 onwards. Figure 2 shows the number of registered rating agencies, with the three major rating agencies being grouped under Big Three and the other agencies under "Others".

Figure 2, based on the sheer number of registered rating agencies, does not suggest that the rating market has an oligopolistic market structure, but suggests healthy competition. In addition to the three major rating agencies, over 20 other agencies are apparently active on the market. Over the course of 2012, other agencies entered the market, on average one agency per year. It should be emphasized that not all rating agencies offer all rating services, it is rather that the majority of these agencies only offer certain rating services (European Securities and Markets Authority, 2019). The existing oligopolistic market structure, despite the number of rating agencies, is clearly based on a further key figure.

In addition to the presentation of revenues over the period and the number of registered rating agencies in the EU, the market shares (here based on annual revenues in the EU) are another important key figure for analysing the competitive situation. The three major rating agencies are shown individually, whereas all other registered agencies are summarized again under "Others".

Figure 2
Number of registered CRAs in the EU 2012-2018



Source: European Securities and Markets Authority (2014-2020)

The analysis of the market shares from Figure 3 shows (in contrast to the number of rating agencies) the large market share of the Big Three and, with it, the oligopolistic market structure. S&P in particular was able to increase its market share over the period under review from 2012-2018. Overall, the three major rating agencies have a market share of over 90 percent. In contrast, the rest (over 20 rating agencies) together have less than ten percent. It is noteworthy here that the number of rating agencies according to Figure 2 has increased, but the market share ("Others") has decreased with 2012 as the reference year.

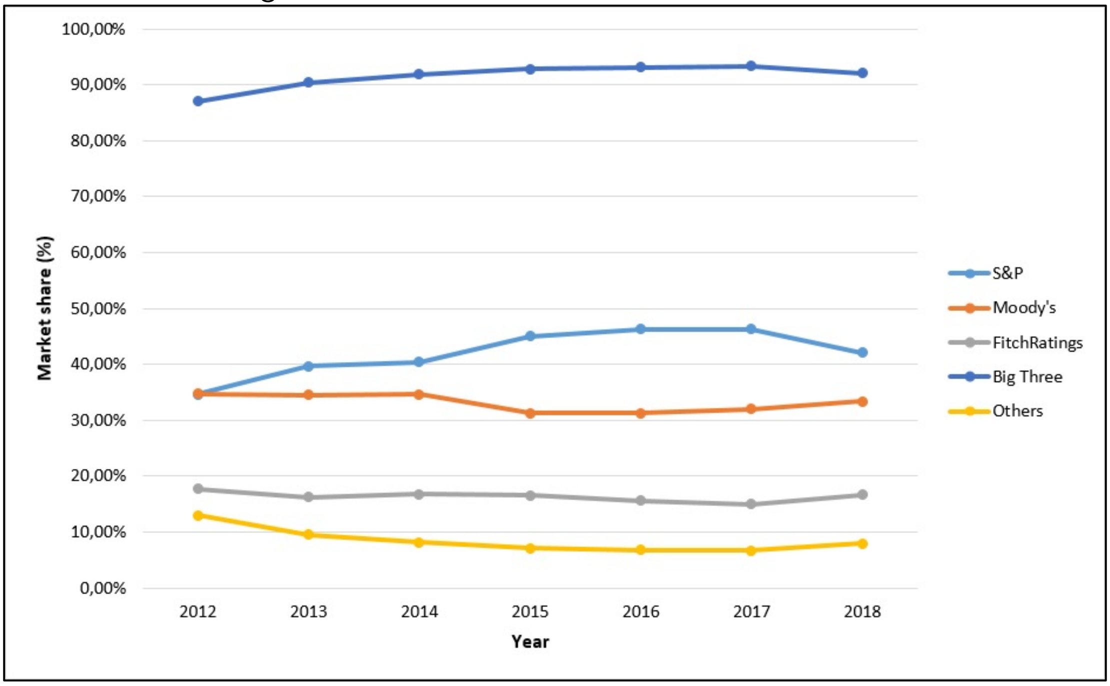
In comparison to the revenues achieved (Figure 1), for which S&P and Moody's showed significant increases at the end of the period under review, it can be seen in connection with the market shares in the EU that the revenues increases tend to have been achieved outside the EU. Otherwise, the respective market share of the corresponding rating agencies in Figure 3 would potentially have increased in a similar way.

Interpretation of the results

The starting point of the empirical analysis was the investigation of the competitive situation of the rating market in the EU. From this, the research question was derived as to whether the entry of the EU Rating Regulation coming into force was associated with a change in the market shares of the Big Three and the oligopolistic market structure.

Relevant key figures from the rating market were analysed to answer this question. First of all, the revenues of the Big Three over the observation period from 2011 to 2018 are shown with reference to different delimitations of the European market. The results show that the revenues of S&P and Moody's in particular increased considerably in the period. S&P revenues have increased by a total of 62 percent since 2011. The rating agency Moody's almost doubled its revenues. Here the increase is about 94 percent. The main revenue increases of Moody's and S&P have apparently been achieved outside of the European Union (taking into account the market shares in the EU), though. FitchRatings was only able to increase revenues by a total of approx. 8.6 percent over this period. The reported revenues of the Big Three refer to a different definition in regional segment reporting. In conjunction with the analysis of market shares, the trend is that the revenues of the Big Three in the EU have remained constant. A stagnation or general decline in revenues of the Big Three in the period under review, which could indicate lower market power or increased competition, cannot be identified with this key figure, though.

Figure 3
Market share of registered CRAs in the EU 2012-2018



Source: European Securities and Markets Authority (2014-2020)

Furthermore, the number of rating agencies registered in the EU by ESMA has been considered since 2012. The numbers show that in addition to the Big Three there are 25 other rating agencies in 2018. The number has increased since 2012 from 22 registered agencies to a total of 28 rating agencies in 2018. This means an increase of approximately 27 percent over the entire period and an average of approximately four percent or one rating agency per year. It shows that there is potential to use other rating agencies and their services. Considering the market shares, this has apparently not yet been exhausted.

The additional inclusion of the market share indicator illustrates in particular the competitive situation on the rating market. The results over the observation period from 2012 to 2018 show the expected clear dominance of the Big Three with over 90 percent market share. The slight increase in the number of rating agencies does not have the effect that they lose market share on a larger scale. All smaller rating agencies together only have a market share of less than ten percent in the EU. The prevailing oligopolistic market structure can be clearly determined on the basis of this key figure.

Taking into account the results of the empirical analysis, it can be stated with regard to the formulated hypothesis that since the entry of the European Union Rating Regulation came into force, the dominant market shares of the Big Three have remained largely unchanged and the associated oligopolistic market structure has pursued to exist in the EU. To date, efforts to strengthen competition and reduce the dominance of the Big Three associated with the EU regulation have not been achieved. Consequently, the hypothesis formulated at the beginning can be validated.

It can be said that the oligopolistic market structure and the associated market power of the Big Three continue. Alternative endeavours always have to assert themselves on the market and, according to the authors' view, will find it difficult to form a competitive alternative. This includes, for example, a network of small rating agencies (Meeh-Bunse & Sattler, 2012; Meeh-Bunse et al., 2014). However, efforts with a chance to be operational should continue to be promoted on the basis of regulation, as it is already the case with the current rating regulation and, for example, the associated commissioning of double ratings for issuers of SFI. In the long term, according to the authors, other rating agencies could assert themselves on the market and build up the necessary reputation leading to more competition and hence to improved market efficiency.

Conclusion

The dominance of the major rating agencies S&P, Moody's and Fitch can be historically explained on the one hand by the anchoring of their ratings in regulatory procedures by the SEC and its forerunner authority, a related registration as a NRSRO in 1975 and subsequent developments. The oligopoly thus solidified over decades. On the other hand, the dominant position can be explained by the reputation of the agencies, which results from their many years of experience. The reputation is reflected in the preference of financial market participants, according to which credit ratings of companies, their financial debt or debt related instruments can only be broadly beneficially placed on the financial markets if they are Big Three rated.

At the EU level, the market structure and the actions of the rating agencies were only increasingly questioned in connection with the financial market crisis and, as a result, measures to regulate and strengthen competition were derived. The EU Rating Regulation clarifies the EU's efforts for more competition in the rating market.

This article describes the competitive situation of the rating market in the context of EU regulation. A directly measurable influence of the EU regulations on the competitive situation represents the limits of this article. The article is also limited to certain indicators for assessing the competitive situation. Further indicators can be analysed in future research projects with regard to the rating market. There is also a need for research to develop alternative options on the rating market that could reduce the dependence on the Big Three. Ideas like a public rating agency, located at the central bank, or a network of smaller rating agencies need to be further researched.

In summary, it can be stated that bare regulatory requirements do not automatically change the competitive situation or that the oligopolistic market structure is necessarily changed as a result. Ex ante regulatory action expectedly has to be impactful in achieving the political goals. Ex post implementation of such action consequently needs to be controlled. The biggest difficulty for the small rating agencies will be to build up the necessary reputation and the associated trust in a rating judgment. The creditworthiness statements must receive the broad acceptance of the financial market participants, which will probably only be possible over a longer period of time or by recourse on valid existing data (Meeh-Bunse & Sattler, 2012). Other potential market solutions, such as a network of smaller rating agencies, could provide further dynamic in the market and possibly meet the efforts to increase competition. Voluntary commitments by investors and issuers to commission and to take into account the judgment of smaller rating agencies could have a strong impact as well as public incentive schemes.

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