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*Anton S. Selivanovsky*

# **FORMATION OF THE CREDIT RATING AGENCY REGULATION IN RUSSIA**

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## **FORMATION OF THE CREDIT RATING AGENCY REGULATION IN RUSSIA<sup>2</sup>**

This Working Paper is dedicated to the new system of legal regulation of credit rating agency (hereinafter “**CRA**”) activity in Russia. The main focus of the new rules is administrative regulation and rigid control of procedural issues by the Russian mega-regulator for financial markets. The author criticizes current legislation and argues that such rules will obstruct CRA activity and adversely affect protection of investors’ and creditors’ rights, and will ultimately lead to an increase in transaction costs.

It is necessary to continue work on CRA regulation in order to develop effective mechanisms to ensure a balance of interests among parties to the credit rating contract, and ensure that investors and the regulator take into account not only legal, but also economic, managerial, organizational and a number of other issues. Regulation of CRA focused only on rigid control of procedural issues by the Bank of Russia will not lead to the desired result. CRA regulation should instead be "delicate and fine."

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<sup>1</sup> Associate professor, Department of Civil and Business Law, National Research University "Higher School of Economics", Candidate of Sciences (PhD) in Law. Address: ul. Myasnitskaya, 20, Moscow, Russia, 101000. E-mail: [aselivanovsky@hse.ru](mailto:aselivanovsky@hse.ru)

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## Introduction

Credit rating agencies (CRAs) are important participants in the economy and perform a necessary function by receiving, processing and analyzing large volumes of information for transformation into credit ratings, which guide the actions (make investments, sale of securities, lend money etc.) of many market participants.

Before 2006 there was no direct regulation of CRAs in any country in the world.

The large-scale crisis that began in 2007 in the United States revealed that CRAs often assigned inaccurate credit ratings. In particular, CRAs assigned high credit ratings to issuers and the issuers' financial instruments, but many of the highly-rated issuers turned out to be bankrupt and payments on their financial instruments ceased.

Investors and rated entities, as well as regulators, were disappointed with CRA activity. The widespread discontent caused a dramatic change in credit ratings of countries such as the US<sup>3</sup> and Russia.<sup>4</sup>

Investors tried to recover the losses incurred by relying on credit ratings from the CRAs themselves, arguing that they relied on credit ratings when purchasing securities, and that it became clear that such ratings were assigned without a full assessment of credit risk. CRAs successfully defended themselves in courts by referring to the US principle of "freedom of speech." However, in considering more recent claims, courts have found that the CRAs acted in bad faith, and have ordered CRAs to begin to compensate damages for the benefit of investors. It was even more difficult to recover losses from CRAs in Europe.<sup>5</sup>

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<sup>3</sup> In August 2011, Standard & Poor's downgraded the US credit rating from the maximum AAA to AA + with a negative outlook. The agency explained its decision by saying that the budget deal reached by the White House and Congress was not sufficient to eliminate the budget deficit and stabilize the economic situation.

<sup>4</sup> Rating agencies Standard & Poor's and Moody's in early 2015 downgraded Russia's sovereign credit rating to speculative grade BB + from BBB- with a negative outlook. See, for example, <http://www.gazeta.ru/business/2015/02/21/6421413.shtml>

<sup>5</sup> See. Arthur R. Pinto, Control and Responsibility of Credit Rating Agencies in the United States, *The American Journal of Comparative Law*, Vol. 54, American Law in the 21st Century: U.S. National Reports to the XVIIth International Congress of Comparative Law (Fall, 2006), pp. 341-356. Matthias Lehmann, Civil Liability of Rating Agencies: An Insipid Sprout from Brussels, *LSE Law, Society and Economy Working Papers* 15/2014. London School of Economics and Political Science Law Department. p. 3- 8. Nan S. Ellis, Lisa M. Fairchild, Frank D'Souza, Is Imposing Liability on Credit Rating Agencies a Good

The following issues were sources of concern regarding CRA activities for regulators in many countries:

- 1) the virtual absence of competition in a rating market dominated by the "Big Three";
- 2) excessive dependence of investors on ratings;
- 3) non-transparency of rating mechanisms;
- 4) the conflict of interest inherent in the CRA business model, in which the issuer pays for services which are "consumed" by others;
- 5) the transition of the conflict of interest from the economic sphere to the political;
- 6) gaps in the legal regulation of CRAs, in particular the lack of responsibility for assigned ratings.<sup>6</sup>

The Russian mega-regulator for the financial market - the Bank of Russia - has repeatedly expressed dissatisfaction with the activities of CRAs.<sup>7</sup> This was caused by excessively frequent and massive increase in the ratings by Russian CRAs agencies in the absence of a compelling reason to do so.

In order to solve these problems, the task of developing the legal regulation of rating agencies was included as a priority on the agenda of regulators of many countries.

In the United States, the Credit Rating Agency Reform Act was adopted in 2006. Regulation No. 1060/2009 of the European Parliament and Council on credit rating agencies was adopted in September 2009.

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Idea?: Credit Rating Agencies Reform in the Aftermath of the Global Financial Crisis, *Stanford Journal of Law, Business & Finance*; Spring 2012; 17, 2.J.P. Hunt, Credit ratings agencies and the 'Worldwide Credit Crisis': the Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, *Columbia Business Law Review*. 109. 207 (2009). H.A. de Savornin Lohman & M.G. van 't Westeinde, Control and Liability of Credit Rating Agencies under Netherlands Law, *Electronic Journal of Comparative Law*, vol. 11.1 (May 2007).

<sup>6</sup>Credit ratings agencies and the "Worldwide Credit Crisis": the Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement. John Patrick Hunt. 2009 *Columbia Business Law Review Inc.*, p. 129-138.

<sup>7</sup>See, for example, <http://bankir.ru/novosti/20150903/sergei-shvetsov-tsb-budet-ubirat-s-rynka-nedobrosovestnye-reitingovye-agentstva-10111569/>, «Doubt cast on ratings» //Vedomosti29.01.2010№ 2533

Russia has adopted the Law on Credit Rating Agencies (hereinafter “**Law on CRAs**”).<sup>8</sup> It is expected that this law will ensure the transparency and independence of CRA activity, and will furthermore protect the interests of creditors and investors.

After analyzing the regulation of rating activity, the author has concluded that, in the process of developing an appropriate legal framework, the Russian legislature became overly preoccupied with forming various complex rules for the entry of new rating agencies to the market and in providing the broadest possible powers to the regulator. At the same time, legal means of protection against unfair ratings at present are not available for either the regulator or for bona fide investors. The twin objectives of protecting investors' rights and of securing the proper development of the financial market in the Russian Federation remain mere declarations in the first article of the Law on CRAs.

The analysis described in this Working Paper leads to the following conclusions:

- 1) The Russian Law on CRAs has introduced strict rules on admission to the CRA market. This new rule applies not only to newly created agencies but also to those that are already function.
- 2) The new rules in the Law on CRAs do not expand the list of CRAs, but will rather reduce it. It is obvious that the stringent requirements described in the Law on CRAs can be met only by a few existing CRAs and by the agency created with the active support of the regulator.
- 3) It is doubtful whether the capacity to ensure the independence of CRA activities exists. On the one hand, CRAs are extremely dependent on the Bank of Russia, since access to the market, the appointment of top managers of the agency, approval of methods, and the ability to provide additional services are all in the hands of the regulator. On the other hand,

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<sup>8</sup> Federal Law on 13.07.2015 № 222-FZ "O deyatelnosti creditnyh ratingovyh agentsv v Rissiyskoy Federacii, o vnesenii izmeneniya v statiu 76.1 Federalnogo zakona "O Centralnom banke Rossiyskoy Federacii (Banke Rossii)" I priznanii utrativshimi sily otdelnyh polozheniy zakonodatelnyh actov Rossiyskoy Federacii" <http://www.pravo.gov.ru>, 13.07.2015

CRAAs depend heavily on their clients, since agencies are able to receive revenue only from clients with other activities are prohibited, and the number of entities in need of ratings is very small.

- 4) The goal of protecting the rights and legitimate interests of the rated entities and those of credit rating users, including creditors and investors, as stated in the Law on CRAAs will not be met. The regulation will lead to additional costs for CRAAs, which will be transferred to clients. Since the number of CRAAs will be very small, this will reduce competition between them and may lead to the establishment of high prices that persons in need of ratings will still have to pay. The expenses for entities being rated will thus increase. In the absence of direct rules on civil liability, CRAAs will not bear responsibility to rated entities, investors or the state. There are no effective mechanisms to protect the rights and legitimate interests of the rated entities and those of the users of credit ratings.
- 5) The introduction of such specific regulation on rating activity differs considerably from traditional regulatory mechanisms used in Russian legislation.

It is necessary to continue the work of developing effective mechanisms to ensure that the interests of parties to the credit rating contract, those of investors, and those of the regulator are balanced. This work must take into account not only legal, but also economic, managerial, organizational, and a number of other aspects.

It appears that the regulation of CRA focused only on rigid control of procedural issues by the Bank of Russia which was introduced by the Law on CRA will not lead to the desired result. Regulation should instead be "delicate and fine".

CRA regulatory issues are studied by many researchers, who have considered regulation and approaches in the United States, Europe, and Australia.<sup>9</sup> In this

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<sup>9</sup>Arthur R. Pinto, Control and Responsibility of Credit Rating Agencies in the United States, *The American Journal of Comparative Law*, Vol. 54, American Law in the 21st Century: U.S. National Reports to the XVIIth International Congress of Comparative Law (Fall, 2006), pp. 341-356.

Working Paper we will focus on some key aspects of CRA activities on the new Russian law:

- 1) Admission requirements for CRAs;
- 2) Regulation of agreements between CRAs and clients; and
- 3) Liability of CRAs.

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Matthias Lehmann, *Civil Liability of Rating Agencies: An Inispid Sprout from Brussels*, LSE Law, Society and Economy Working Papers 15/2014. London School of Economics and Political Science Law Department. p. 3- 8.

Nan S. Ellis, Lisa M. Fairchild, Frank D'Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agencies Reform in the Aftermath of the Global Financial Crisis*, *Stanford Journal of Law, Business & Finance*; Spring 2012; 17, 2.

J.P. Hunt, *Credit ratings agencies and the 'Worldwide Credit Crisis': the Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, *Columbia Business Law Review*. 109. 207 (2009)

James Cooper, John Edmond, Zoe Millington-Jones, John Imhoff and Ned J. Kirk. *Tide Is Turning Against Credit Rating Agencies*, April 3 2013.

H.A. de Savornin Lohman & M.G. van 't Westeinde, *Control and Liability of Credit Rating Agencies under Netherlands Law*, *Electronic Journal of Comparative Law*, vol. 11.1 (May 2007).

Prof. Dr. Brigitte Haar, LL.M. (Univ. Chicago), *Civil Liability of Credit Rating Agencies after CRA 3 – Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence*, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02.

James Cooper, John Edmond, Zoe Millington-Jones, John Imhoff and Ned J. Kirk, *Tide Is Turning Against Credit Rating Agencies*, April 3 2013.

## Admission of CRAs to the market and CRA - regulator relations

The Russian legislature did not introduce any license for rating activity, and furthermore did not establish a regime of CRA self-regulation. Presumably during the legislation process, the small number of players in this market was taken into account, as well as the fact that self-regulation of CRA would not sufficiently protect the rights of rated companies and investors.

The legislation instead established that access to this market was dependent on the formation by the regulator – the Bank of Russia – of a register of credit rating agencies (hereinafter, the “**CRA Register**”).<sup>10</sup>

Outwardly it may seem that entry into the market is only a matter of completing a registration procedure for the register maintained by the Bank of Russia, as established by law. In fact, however, this is not so: the procedure is very complicated, and completing it does not guarantee inclusion in the CRA Register.

In order for the Bank of Russia to enter the data of a rating agency into the CRA Register, the applicant has to submit an application and a voluminous package of documents, which includes:

- 1) documentation of CRA shareholders, including information about the persons who directly or indirectly (through controlled entities), independently or jointly with other persons, control more than 10 percent of the votes at a general meeting of shareholders;
- 2) documentation confirming that the applicant has a minimum capital of 50 million rubles;
- 3) description of the CRA’s corporate governance;
- 4) documentation of all managers, members of the board of directors and credit analysts;

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<sup>10</sup> [http://www.cbr.ru/finmarkets/?PrId=supervision\\_ra](http://www.cbr.ru/finmarkets/?PrId=supervision_ra) (05.01.2016)



5) documents confirming the qualifications of a number of senior managers and credit analysts;

6) internal documents describing the methodology applied.

The Bank of Russia considers the submitted documents over a period of six (!) months (Law on CRA art. 4 p. 3). The regulator has very wide range of grounds for refusing to include the CRA in the register.

The new procedure of formation of the CRA registry sets outrageously high entry barriers (many stringent requirements, the minimum capital requirement, and so forth). Thus, the Russian legislature, unlike the European and American legislatures, has deliberately reduced competition in the market.

CRA on the CRA Register can perform rating activities in Russia in full, and assign credit ratings on the basis of a national scale.

Foreign CRAs are able to perform only some elements of rating activity on the territory of Russia. This activity must be conducted via a Russian subsidiary, after the Russian branch has been entered into a special register of foreign CRA branches by the Bank of Russia.

Despite the fact that rating activities are not licensed, the law has established that a CRA may only carry out rating activities. The law expressly prohibits CRAs from combining rating activities with other activities (Law on CRA art. 3 p. 3). The Law on CRAs introduced rule of exceptional capacity for CRAs. At the same time, the Law on CRA assumes that CRAs will provide additional services (these include drawing up market business cycle forecasts, evaluating the activities of organizations, including by the assignment of ratings other than credit ratings, the assessment of economic trends, analysis of pricing and other analysis, as well as related services for the dissemination of data). The CRAs must, however, coordinate the list of such services with the Bank of Russia (!).

If we turn to CRA regulation in the United States<sup>11</sup> and the European Union,<sup>12</sup> we see that legislation is aimed at separating rating services from consulting services. European legislation requires that a CRA establish separate departments, one of which might advise companies on the issuance of bonds, and another department which would assign ratings to these bonds. A European CRA has the right to provide financial analysis services, and to provide financial advice and other opinions on the value or price of a financial instrument or liability.

It seems that the introduction of a regime of "specific approval" in Russian legislation is not a good solution, for the following reasons:

- 1) This rule provides the regulator (the Bank of Russia) with excessive and uncontrollable authority over CRA business activity. This can significantly affect the independence of CRAs.
- 2) Exceptional capacity affects the formation of the CRA' pricing policy. Given the fact that the only source of income for a CRA is the client's fee for assigning and maintaining of ratings, it is easy to assume that such remuneration will be very significant. Considering the narrow range of clients in Russia, each CRA will cherish every client, and this dependence on clients will affect the independence of the opinion on the creditworthiness of the client.

## **CRA Independence**

CRA market access issues and CRA capacity are connected with the duty of a CRA to ensure the independence of its ratings.

CRAs should provide (Law on CRA art. 3 p. 9):

- 1) rating activities independent of all political and (or) economic influences;
- and

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<sup>11</sup> Including the Credit Rating Agency Reform Act of 2006 and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

<sup>12</sup> EU Regulation on credit rating agencies No. 1060/2009 of the European Parliament and Council on September 16, 2009.

- 2) Prevention and detection of conflicts of interest, as well as management and disclosure of conflicts of interest.

The Law on CRA does not, however, describe what is meant by independence of rating activities. Only a few scattered provisions may be taken as guidelines:

- 1) revocation of an assessed credit rating is allowed only in case of revelation of false information provided by a CRA;
- 2) CRAs have no right to revoke assessed credit ratings on the basis of decisions of foreign state authorities, subjects of international law, or other entities, unless such decisions directly affect the ability of the rated entity to fulfill the financial obligation or the credit risk of a financial obligation or a financial instrument it has undertaken;
- 3) remuneration of the rating analysts, including the chairmen of rating committees, should not depend on the income the CRA obtains from the rated entity or from the entity which exercises control or exerts a considerable influence on this rated entity (Law on CRA art. 10 p. 7).

The Law on CRA also introduces detailed rules for the rating agencies to observe in situations in which possible conflicts of interest have been identified.

A CRA is obliged to take measures to prevent impact on its credit ratings and credit rating outlooks from an existing or potential conflict of interest involving the CRA itself, its shareholders, rating analysts and other employees, and/or persons exercising control or significant influence over the CRA. The CRA must identify existing or potential conflicts of interest, describe how it will manage these conflicts, and disclose information in cases where conflicts of interest may affect the analysis and opinions of rating analysts.

The fact that almost all CRA income is obtained from issuers (borrowers) is, without a doubt, fertile ground for the emergence and development of conflicts of interest.

The opinion has been expressed that CRAs should not be allowed to accept fees from issuers because of the conflicts of interest that arise from this situation.<sup>13</sup>

However, as experts have noted,<sup>14</sup> the economic reality is as follows: first, issuers still hope to influence their credit ratings positively, and second, issuers argue that, in the absence of a formal contractual relationship with the CRA, there can be no confidence in the completeness and accuracy of the data used for the analysis by the rating agency.

### **Disclosure of information by CRAs**

In order to ensure the transparency of rating activity, the rating agency is obliged to create and maintain a website on the Internet and to constantly disclose a vast amount of data (Law on CRAs art. 13), such as:

- 1) a list of credit ratings and credit rating forecasts, as well as a publicly-available list of revoked credit ratings;
- 2) a list of existing and potential conflicts of interest;
- 3) rules for credit rating disclosures and disclosures of other related messages, including credit ratings forecasts;
- 4) a description of pricing policy, including pricing policy for different types of instruments;
- 5) a description of the methodology used for rating models (including methods of calculation and construction), key rating assumptions, lists of all quantitative and qualitative factors (indicating the limitations for expert opinions by analysts for each such factor), and data sources;
- 6) a list of credit ratings assigned during the previous calendar year, indicating the proportion of unsolicited credit ratings in the total number of credit ratings assigned annually;

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<sup>13</sup> Lawrence White (NYU), Fixing the Rating Agencies: Is Regulation the Answer? <http://www.voxeu.org/index.php?q=node/2958> (05.01.2016)

<sup>14</sup> See for example, Hainsworth Richard. Regulation of credit rating agencies activity // Dengii credit. 2009. № 7.

- 7) a list of the rated entities and other persons who contributed more than 5 percent to the CRA's annual revenue by the end of the preceding calendar year.<sup>15</sup>

The Law on CRAs introduced general rules governing how CRAs are to interact with a rated entity during the publication of credit ratings or credit rating forecasts (Law on CRAs art. 14). This interaction has two phases: 1) the CRA alerts the rated entity of its intention to disclose the rating or rating forecast; 2) the rated entity is entitled to express its opinion only concerning the removal of factual errors and exclusion of confidential information. Changing information at the request of the rated entity on other grounds is not allowed.

The law gives the Bank of Russia broad and unrestricted authority to impose additional requirements for the disclosure of credit ratings and credit rating forecasts.

The legislature considers CRA activity important to the public. CRAs are therefore obliged to disclose a large volume of information. However, there is no liability for a breach of this obligation.

## **Professional standards**

The Law on CRA does not use the concept of "standards." Instead, it defines in detail the methodology on the basis of which a CRA should assign credit ratings and carry out monitoring – which, in practice, is very close to adopting standards.

According to the law, each CRA is required to form a committee on methodology (Law on CRA art. 12 pp. 13-15). This committee approves rating methodology in the form of an internal document. This document should be submitted to the Bank of Russia together with the application for entry into the

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<sup>15</sup> This disclosure should provide the public with information about the dependence of the rating agency on a particular client. A "threshold" of 5% or more of the agency's annual revenue is considered acceptable.

CRA register. The Bank of Russia reviews the document and evaluates it for compliance with requirements outlined in the Law on CRAs and Bank of Russia regulations. If it determines that the methodology does not meet these requirements, it will refuse to enter the applicant's information into the CRA register

A CRA is obliged to submit constantly to the Bank of Russia the methodology is employing as well as all amendments made to the methodology. Thus it is likely desired that the regulator would have a "master copy" of current methodology. This rule is introduced so that the Bank of Russia may 1) verify that the methodology complies with the requirements of the law, and 2) monitor the CRA's use of its own methodology in assigning ratings and making rating forecasts.

According to the law, a CRA's operations shall be guided by its methodology. The Law on CRA has introduced the following rules:

- 1) the CRA has the right to deviate from its methodology in exceptional cases, e.g., if the applied methodology does not correctly consider or take into account the peculiarities of the entity to be rated and in cases if, following the methodology, a distortion of the credit rating and/or the rating forecast may ensue;
- 2) every case of deviation from the methodology used should be documented and disclosed on the CRA's official Internet website when the credit rating or the credit rating forecast is published, with the reasons for the deviation indicated;
- 3) systematic deviation from the approved methodology is not allowed. If deviations from the methodology occur more than three times per calendar quarter, the CRA is obliged to examine the methodology and revise it.

- 4) the CRA shall disclose information about the impact of assumptions used in the methodology to any change in credit ratings assigned in accordance with such methodology;<sup>16</sup>
- 5) If CRA finds errors in the methodology used which have affected or may affect the credit ratings and/or rating forecasts, the CRA should amend the methodology, publish amendments on its website and submit the amendments to the Bank of Russia with information about the identified errors and the measures taken.

### **The relationship between the CRA and the client – the credit rating contract**

Borrowers and issuers need credit ratings to attract financing from banks and the financial market. They enter into contracts with a CRA to obtain the credit ratings. The list of operating CRAs is rather short.

When drafting the features of the credit rating contract, the legislature decided not to use traditional conditions, but considered it necessary to introduce a number of innovations to solve the same problems which are solved by such instruments as a public contract or contract of adhesion. These problems include the inadmissibility of unilateral refusal on the part of the professional provider of the services to enter into a contract, the setting of equal conditions for all "clients," and others.

As a result of the analysis given below, it is possible to conclude that there are obvious defects in the new conditions under which the rating agencies have to receive preliminary approval from the regulator (the Bank of Russia) for unilateral refusal to enter into contracts: rating agencies are able to propose unacceptable conditions in the contract and to avoid restrictions established by the Law on CRAs. The new Law on CRAs needlessly abandon proven techniques for solving these problems. .

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<sup>16</sup> The law introducing this rule, however, does not determine the legal consequences of its violation. In this regard, the rule actually is declarative in nature.

A rating contract is likely to be related to the paid services contract under which a CRA carries out "analysis of the client's risk and the credit ratings assignment" under the instructions of a client (the rated entity),<sup>17</sup> and the client agrees to pay for these services.

The rated entity becomes dependent on the CRA by signing a contract with the CRA by which the information about the assigned ratings is publicly disclosed. In addition, such contracts often include conditions related to credit ratings. For example, credit rating agreements often include conditions on the right of the bank to demand early repayment of the loan if the borrower's credit rating drops below a certain value or the rating is withdrawn, or if the borrower refuses to be rated.

Of course, the rated entity has the ability to terminate the contract with the CRA. However this will lead to the withdrawal of the ratings and, accordingly, the rated entity would be at risk of incurring claims from banks and other lenders.

### **Entering into credit rating contract**

The CRAs are commercial organizations (Law on CRA art. 2) with the primary purpose of making a profit by carrying out rating activity. The legislature assumes there will be several such organizations in the market, so it has introduced some specific rules on how credit rating contracts are entered into

It is known that civil law provides for the form of a public contract and for a contract of adhesion which include a number of restrictions for a "strong party" to the contract (for example, for a company providing services to a non-professional customer).

The Law on CRAs refers neither to the concept of public contracts, nor to adhesion agreements.

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<sup>17</sup> A "rated entity" is a legal entity or public entity (state, municipality etc.) whose ability (creditworthiness, financial security, financial stability) to fulfill a financial liability it has undertaken is directly or indirectly assessed in a credit rating (Law on CRA art. 2)



Perhaps, given the small number of rating agencies and the need for companies to receive credit ratings in order to carry out a number of economic operations, the legislature has created a set of rules that contain consequences reminiscent of the provisions in a public contract and a contract of adhesion.

The Law on CRAs introduces a very unusual rule for Russian law, under which the rating agencies have the right refuse to sign the contract with the person (legal entity or a public legal entity), "in accordance with the preliminary grounds approved by the Bank of Russia in the manner prescribed by it. Such grounds should be disclosed to the rated entities before signing the credit rating contract" (Law on CRA art. 3 p. 6). The following are grounds for refusal to enter into a contract, subject to approval by the Bank of Russia:<sup>18</sup>

- 1) violation of the principle of independence of the rating activity;
- 2) the need for "protection" from political or economic influence;
- 3) violation of the principles of good faith, reasonableness and equivalence in the economic relationship between the parties to the contract;
- 4) identification of false information in the documents submitted to the CRA.

The introduction of such rules seems to be very strange.

Firstly, the right of a commercial organization to carry out its own business is made dependent on the will of the regulator performing public functions.

Secondly, the legal consequences of such refusal, given the CRA's availability to provide the relevant services to the clients, are not determined.

Thus, there is considerable doubt that this rule would work in practice.

There are also grounds for applying the rules of adhesion agreements to the credit rating contracts, given that CRAs are constantly carrying out rating activities and that the agencies develop and offer the drafts of such contracts for review.

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<sup>18</sup> Directive of the CBRF 30.11.2015 № 3861-Y "O poryadke soglasovaniya osnovaniy otkaza kreditnym ratingovym agentstvom yuridicheskim licam I publichno-pravovym obrazovaniyam v okazanii uslug po osyzhestvleniu ratingovyh deystviy po nacionalnoy shkale dlya Rossiyskoy Federacii."

The main consequence of this qualification is that the rated entity has the right to demand the termination or modification of the contract if the contract deprives the rated entity of the rights usually given under contracts of this kind, while excluding or limiting the liability of the CRA for breach of obligations. The rated entity also has this right if the agreement contains other clearly burdensome conditions for the adhering party which, based on a reasonable understanding of its interests, the party would not accept in the event it had the opportunity to participate in determining the terms of the contract. From a practical point of view, it would be extremely difficult for a rated entity to take advantage of this right, as it would lead to the withdrawal of its ratings,<sup>19</sup> and the rated entity would risk incurring claims from banks and other creditors.

### **Price of the credit rating contract**

The Law on CRA introduced a few important rules for preventing conflicts of interest caused by the fact that the rated entity pays for the service and it is interested in receiving the highest possible rating. As a rule, creditors of the rated entity, investors in its securities, and the regulator are the consumers of the ratings.

A CRA must disclose its pricing policy for different types of rating objects on an ongoing basis.

I believe that the legislature thus tries to force CRAs to establish equal prices for all rated entities and to exclude the possibility of introducing advantages for certain clients, in spite of the fact that a credit rating contract is not a public contract.

Usually the price for services is set for one year, and the price for services for the next period is agreed on by the parties at the end of the contract period. The following factors play an important role when negotiating prices for the new period:

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<sup>19</sup> Loan agreements list a number of events that trigger the borrower's default, including withdrawal of ratings. As soon as the bank-creditor learns of the event of default, the bank has right to recall the loan.

- 1) the need of the rated entity to maintain its credit rating from the same CRA over a long period;
- 2) the vulnerability of a rated entity to the negative business impact that a decrease in its rating may have ;
- 3) the lack of competition in the market of rating services;
- 4) the fact that increasing the regulatory requirements governing CRA activity leads inevitably to an increase in compliance costs for CRAs, with these costs offset by increasing prices for CRA services.

Thus, there is reason to believe that the rated entity is in a "weak position" vis-à-vis the CRA when discussing prices for the next period.

## **Liability of CRAs**

Probably the most acute problem of CRA activity is how to determine responsibility for assigned ratings.

A discussion of the legality of assigning liability to CRAs has been ongoing for some time.<sup>20</sup> Regulators, law enforcement agencies, and entities which consider themselves victims of CRA actions have had to rely on general rules and principles of the applicable laws of particular countries.

It is necessary to address the question of what offenses the rating agencies should be liable for.

A CRA assigns a credit rating to the subjects of market participants (legal entities and public entities) and to financial instruments on the basis of a credit rating contract concluded with the relevant subject, or without such an agreement (a so-called "unsolicited" rating).

The Law on CRAs introduces the following obligations of rating agencies:

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<sup>20</sup> Matthias Lehmann, Civil Liability of Rating Agencies: An Inspid Sprout from Brussels, LSE Law, Society and Economy Working Papers 15/2014. London School of Economics and Political Science Law Department. [http://www.lse.ac.uk/collections/Law/wps/WPS2014-15\\_Lehmann.pdf](http://www.lse.ac.uk/collections/Law/wps/WPS2014-15_Lehmann.pdf) p. 3-8. (06.03.2016)

- 1) to develop, approve and follow a methodology;
- 2) to disclose the assigned ratings and forecasts on its website;
- 3) to provide identification of conflicts of interest, to manage them, and to avoid the influence of conflicts on the ratings;
- 4) to have a defined corporate governance structure, to hire employees with specific skills, and so forth.

"Standards" for rating activity are set by the methodological committee of each CRA, but not by law or a normative act of the Bank of Russia. A credit rating is an opinion on the ability of the rated entity to fulfill its undertaken financial obligations (i.e., its solvency, financial security, and financial stability), or can be considered the credit risk of individual financial obligations or financial instruments expressed using the rating categories. In other words, the credit rating is always a subjective evaluation of the CRA.

The Law on CRAs makes no direct reference to an obligation on the part of a CRA to provide an unlimited range of persons with a "quality", "authentic", or "certified" rating, which anyone can rely on as verified information. In the absence of such an obligation, it is difficult to determine what action or inaction on the part of a CRA should be recognized as an offense. Accordingly, it is difficult to determine the type of sanction to which the offender may be subjected.

***Criminal liability.*** The Criminal Code of the Russian Federation contains no article describing criminal activity in relation credit rating.

The only grounds for a criminal offense by a CRA employee in the line of work is the misuse of insider information (Criminal Code of the Russian Federation, art. 185.6).

CRAs or their employees cannot be sanctioned administratively. This is surprising because the Law on CRAs introduces an extremely tough administrative regime for regulation of the agencies, but violation of the rules is not grounds for administrative liability.

Note that Section IV of the EU Regulation contain an impressive list of administrative fines that may be imposed on rating agencies in case of violations committed during their operations. There are general rules for liability, administrative procedure, and fine imposition. Annex III to the EU Regulation contains a list of violations for which a CRA may be held liable (including violations connected with conflicts of interest, organizational requirements, disclosure of information, and the creation of obstacles to implementing control activities).

In fact, the only administrative punishment for CRAs in Russian law is to eliminate them from the CRA register (Law on CRA art. 15, 16). The use of this recourse is completely at the discretion of the Bank of Russia.

At the moment, criminal and administrative responsibility has not been established with respect to CRAs or CRA managers and employees, except for criminal responsibility for the misuse of insider information and administrative responsibility in the form of elimination from the registry.

***Civil responsibility.*** A complete mechanism for protecting the rights of bona fide investors should include not only public law methods of protection, but also private law methods of protection, in the form of providing bona fide market participants an opportunity to sue for damages caused to the investor by the negligent actions of other market participants.

It is obvious that a reasonable investor assessing the prospects of entering the financial market (for whom the opinion of professional "third parties" such as auditors and CRAs is a valuable input) will, first of all, ask itself or its consultants a simple question: "How exactly will my rights be protected in the case of abuse or dishonesty on the part of other market participants?"

If the set of available methods of legal protection seems ineffective, a reasonable investor is likely to refrain from entering to the financial market.

In addition to investors, a rated entity may need civil protection. In disputes between a CRA and another party to a credit-rating contract, the issue is one of

contractual liability. Non-contractual liability becomes an issue in the case of a dispute between a CRA and the credit rating consumer or with an entity assigned an unsolicited rating.

It seems that a rated entity may make the following claims against a CRA:

- 1) violation of the terms of services to be provided;
- 2) violation of the confidentiality of information transferred under agreement;
- 3) assignment of a "bad" rating.

The nature of the first two disputes does not relate to the purposes of our research, because the issues they involve are not specific to CRAs.

Situations in which clients are not satisfied with the credit ratings they have been assigned, or with a credit downgrade or negative forecast, are quite frequent. Typically the clients terminate agreements with the CRA that issued the rating without any legal proceedings.<sup>21</sup>

First of all, the Law on CRAs introduced a direct ban on establishing remuneration for CRA services based on the level of the assigned credit rating or rating forecast, or on the rated entity's consent with the assigned credit rating or forecast.

This way, the grounds for holding a CRA liable (i.e., for reimbursement of damages to the rated entity) for assigning a "low" rating would be significantly reduced. In theory, a rated entity could base its position if a CRA violates its own methodology and consequently is found to have improperly performed its duties under contract. However, it may in practice be difficult for a potential plaintiff to bring a suit against a CRA, as CRA methodology always contains a number of issues which depend on subjective opinions on which opinion shall be made.

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<sup>21</sup> For instance, VTB Group has refused services of Fitch rating agency. See <http://www.kommersant.ru/doc/2398618>

## **Non-contractual civil liability of CRAs**

Given that the users of credit ratings are entities which do not have a contractual relationship with CRAs, the circle of potential victims of incorrect ratings is very wide, and includes:

- 1) bona fide investors who entered into agreements with the rated entity based on credit ratings;
- 2) bona fide investors who purchased securities of the rated entities based on credit ratings;
- 3) entities who have received an unsolicited rating or a rating change which impaired their ability to attract funding, or had other adverse consequences;
- 4) the State (or its authorized bodies), which is interested in the stock market functioning according to fair "rules of the game."

I believe that the only way to protect the rights of such bona fide entities is probably by allowing the qualification of CRA actions (behavior) as unfair. Assigning unfair ratings can therefore be considered a tort which results in damage to bona fide participants in the financial market. Under certain conditions a CRA may be considered a tortfeasor and held civilly liable for misrepresentation according to the general principle of torts and the rules of Chapter 59 of the Civil Code. However, such civil cases have not yet appeared in Russia. In my opinion this task is extremely difficult for the claimant, and there is no certainty that the courts will agree with the qualification of the CRA's actions as unfair.

As the experience of the USA and Europe shows, if legal cases against the CRA are admitted, the existing legislation would have to be supplemented by new special rules in order to foster the growth of transparent rules for holding CRAs liable. These new rules would have to take into account the balance of interests between the CRA, the entities assigned credit ratings (including unsolicited ratings), and investors and lenders. It is important that CRA be responsible not for the "wrong assessments," but for intentional acts and gross

negligence in issuing ratings that affected the assignment of the "doubtful" credit ratings to the issuer or issuers of financial instruments which influenced to implicit behavior of investors and lenders.<sup>22</sup>

Researchers have discussed how to determine a maximum value of damages that may be claimed from a CRA. It remains unclear how to determine this value. Furthermore, this "ceiling" may not limit liability for intentional offenses.

### **Conclusion**

It follows from the above analysis that the new Russian legislation on credit rating agencies is still far from ideal.

During development of laws on CRAs, it is reasonable to consider the following fundamental questions:

- 1) what actions / inactions the credit rating agencies should be liable for;
- 2) who will be entitled to sue rating agencies for damages;
- 3) what losses should be compensated;
- 4) standards of proof both for a plaintiff and a CRA;
- 5) types of responsibility, including joint, individual, subsidiary;
- 6) limitation of liability.

In order to develop effective mechanisms for balancing the interests of parties to a credit rating contract, the interests of investors, and the interests of the regulator, it is necessary for future efforts to take into account not only legal, but economic, managerial, organizational, and a number of other aspects.

In order to form a system for protecting the rights of bona fide market participants (including retail investors), it is necessary to form a body of rules that will be applied in practice. It is also necessary to seek a reasonable balance between the interests of consumers of ratings, CRAs, entities assigned unsolicited ratings, and investors. Other countries, such as the USA, Australia, and Europe,

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<sup>22</sup> Possibly trying to adopt this approach, the Russian legislature has paid attention to methodological questions such as how credit ratings are assigned and the "obligation" of a CRA to apply its own techniques.



have chosen this approach. Each country has its own legal system, economy, and rating agency industry. No country that has already adopted all the relevant laws is completely satisfied. The discussion is ongoing, and suggestions for improvements are still being made. I believe it is reasonable to hope that Russian specialists can also participate in the development of an efficient system for regulating CRAs.

## **Contact details**

Selivanovsky Anton S.

Higher School of Economics, Law Faculty, Associate Professor of Civil and Business Law Department, Address: ul. Myasnitskaya, 20, Moscow, Russia, 101000. E-mail: [aselivanovsky@hse.ru](mailto:aselivanovsky@hse.ru).

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