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Asymmetry in Empowering and Disempowering Private Intermediaries: The Case of Credit Rating Agencies

By
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This article analyzes the empowerment and disempowerment of credit rating agencies (CRAs) as private regulatory intermediaries. Until the recent financial crisis, regulators heavily relied on private credit ratings to impose risk-sensitive requirements on financial market actors (targets). Regulatory use of credit ratings was instrumental in *empowering* CRAs because regulatory authority was delegated to them and their own private power was bolstered by public endorsement. But regulators' subsequent efforts to *disempower* the CRAs—more recently regarded as dysfunctional "runaway" intermediaries—have proven costly, complicated to do, and hardly consequential in limiting CRAs' de facto power. This dynamic reveals a path-dependent power shift in favor of private intermediaries that is more pronounced (1) the larger the intermediary's own sources of power when an RIT arrangement is established, (2) the larger the transfer of authority to the intermediary, and (3) the longer regulators rely on the intermediary.

Keywords: credit rating agencies; regulatory intermediaries; power dynamics; path-dependence; delegation; private authority

Credit rating agencies (CRAs) are powerful actors in global financial market governance. Even after the latest global financial crisis, which spurred broad-based allegations that CRAs lacked reliability and integrity and led to pledges to reduce "overreliance on CRAs" (Partnoy 2009; see Hill 2011; Pagliari 2012; Porter 2010), a small number of private rating firms continue to determine costs of borrowing and access to capital for public and private debtors. Investors still follow CRAs' standard of

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creditworthiness, and even strong sovereign states zealously seek to preserve their top ratings. This article draws on and enhances the RIT framework to explain how CRAs could rise to such arguably excessive power, and what makes CRAs' power so persistent.

The case of CRAs underlines the value-added of the RIT model as outlined by Kenneth Abbott, David Levi-Faur, and Duncan Snidal (this volume) for understanding the power of private third-party governors (see also Galland; Loconto; Lytton; van der Heijden, this volume). To capture the persistent power of CRAs, it is crucial to retrace how the regulatory use of credit ratings in the United States and elsewhere constituted CRAs as regulatory intermediaries (I). CRAs fulfilled risk-assessment functions on behalf of public regulators (R), which allowed the latter to impose risk-sensitive, ratings-dependent requirements on financial market actors (targets, T). Regulatory use was instrumental in *empowering* CRAs because it entailed the delegation of regulatory authority[1] and bolstered CRAs' own private sources of power with public endorsement (Bruner and Abdelal 2005; Kerwer 2005; Nölke 2004; Partnoy 2009; Sinclair 2005).

But regulators that initiate public-private schemes of indirect governance while sitting in the driver's seat may not stay there in the longer run. As the RIT arrangement endures, power may shift from the regulator toward the intermediary. In the case of CRAs, regulators' post–financial crisis efforts to *disempower* CRAs by stopping the regulatory use of credit ratings have proven complicated and hardly effective. CRAs' power persists despite costly private governance failures and regulators' efforts to regain control over their dysfunctional and unaccountable "runaway" intermediaries (Hill 2011; Kruck 2016).

This article advances the original RIT model by proposing a path-dependent power shift (PDPS) approach that explains *when* and *why* significant shifts of power in favor of private intermediaries[2] will occur, thus constraining regulators' attempts to disempower runaway private intermediaries. Combining principal-agent, private authority, and historical-institutionalist perspectives, I argue that *(1) the larger the private intermediary's own sources of power when an indirect governance arrangement is established, (2) the larger the transfer of regulatory authority to the private intermediary, and (3) the longer regulators rely on this intermediary, the more costly and difficult it will be for regulators to disempower the runaway intermediary*. As I elaborate below in theory and empirics, these variables are not merely additive but interact to produce (more or less) pronounced power shifts in favor of incumbent intermediaries. They do so via material as well as ideational mechanisms of path-dependence, that is, progressively increasing resource dependence of the regulator and normalization and

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legitimation of reliance on the intermediary, both of which constrain radical departures from paths of intermediary empowerment.

I illustrate how the PDPS approach can make sense of power dynamics in RIT schemes that could not be fully captured by any one of the PDPS approach's components alone in an "analytical narrative" that retraces the asymmetric roles states have played in empowering and disempowering CRAs (see Büthe 2002). However, the PDPS approach should be relevant for analyzing a lot of RIT schemes beyond CRAs for three reasons.

First, most indirect modes of regulation involve some (varying amount of) empowerment or endorsement of the intermediary by the focal regulator as captured by theories such as principal-agent or, alternatively, orchestration theory (Abbott et al. 2015; see Lytton, this volume, for a network perspective). Second, intermediaries often have or develop their own capacities and sources of authority; so we need theories of private authority that take intermediaries' capacities and authority into account alongside the regulator's actions. Third, most RIT arrangements are designed to last, favoring the emergence of institutional path-dependencies and calling for a dynamic theoretical perspective on how RIT schemes develop over time. Comparative statics accounts of $\mathbf{R} \rightarrow \mathbf{I} \rightarrow \mathbf{T}$ relations fail to draw an accurate and complete picture of their evolution. More adequate models recognize the role of history, regulatory path-dependence, and institutional legacies in explaining (variation in private) intermediaries' power to shape regulatory outcomes (see Farrell and Newman 2010; Mattli and Seddon 2015).

If these presumptions and the PDPS approach are empirically on the mark, path-dependent power shifts, limiting regulators' ability to disempower intermediaries, will be a pervasive feature of RIT arrangements. Further research should seek to rigorously test PDPS and compare successful and unsuccessful attempts of intermediary disempowerment to empirically determine the conditions under which different outcomes will arise.

In the remainder of this article, I first develop the PDPS approach. I then analyze how the constitution of CRAs as regulatory intermediaries enhanced their power. After that, focusing on the U.S. regulatory setting, I retrace how regulators have sought to cut back CRAs' power following the financial crisis by rescinding their delegated authority, but have largely failed in this endeavor. Rescinding delegated authority is difficult for regulators, because after decades of extensive reliance on CRAs regulators have become dependent on CRAs' services, for which there are few (effective) substitutes (see van der Heijden, this volume, for a similar argument on increasing dependence on intermediaries). Moreover, even if rescinding were possible, it would now have few consequences for CRAs' de facto power, because—at least partly due to their regulatory empowerment—CRAs have become strongly embedded in private capital market practices and structures. This makes disenchanted regulators focus on incremental reregulation and shored-up oversight of CRAs. But, paradoxically, reregulation may further solidify CRAs' authority, as it institutionally inscribes CRAs as legitimate and perfectible governance actors, rather than mere purveyors of opinions or providers of mundane services. I conclude by highlighting a broader "intermediary selection dilemma" that follows from the PDPS argument.

A Dynamic and Synthetic Approach to the Public (Dis-)empowerment of Private Intermediaries

Prevailing theories of indirect modes of governance—most notably principal-agent theory (see Green 2014; Hawkins et al. 2006; Tallberg 2002)—and theories of private authority (see Cutler, Haufler, and Porter 1999; Green 2014; Hall and Biersteker 2002; Nölke 2004; Sinclair 2005) tend to either overplay or underplay the role of public regulators in (dis-)empowering private governors while neglecting the importance of path-dependence and endogenous shifts of power in dynamic RIT settings.

By contrast, the PDPS approach to the study of private regulatory intermediaries takes into account both the effects of public empowerment—that is, the depth of delegation and public endorsement emphasized by principal-agent theory—and the extent of intermediaries' own private sources of power stressed by researchers of private authority. Moreover, drawing on insights of historical institutionalism (Farrell and Newman 2010; Mahoney 2000; Pierson 2000), the PDPS approach captures how history, previous institutional choices, and the duration of RIT schemes matter. Last but not least, historical-institutionalist reasoning helps us to theorize how (1) intermediaries' own sources of power, (2) regulatory empowerment, and (3) the longtime institutional entrenchment of RIT arrangements propel material (i.e., progressively increasing resource dependence) and ideational (i.e., normalization and legitimation) mechanisms of path-dependence that underlie the evolution of RIT schemes and drive power shifts in favor of the intermediary.

Public (dis-)empowerment and private sources of power

Principal-agent theory offers important insights into the reasons for delegation, the sources of agency losses, principals' design of control mechanisms and their opportunities for recontracting, all of which are important for analyzing the (dis-)empowerment of private intermediaries. Even proponents of private authority (Cutler, Haufler, and Porter 1999; Hall and Biersteker 2002; Nölke 2004; Sinclair 2005), who are critical of such a "stubbornly state-centric" view (Cutler, Haufler, and Porter 1999, 16), acknowledge that state acquiescence or recognition is (at least) a permissive basis for private authority (Cutler, Haufler, and Porter 1999, 19).

Yet this position underplays the direct and indirect empowering effects of delegation to and endorsement of (private) intermediaries. State support—material and immaterial, direct or indirect—matters for the performance and power of private authorities (Genschel and Zangl 2014). Public empowerment and recognition add additional sources of delegated authority to private intermediaries' resource endowments and may contribute to intermediaries' expanding their independent power, multiplying (not merely adding to) their power resources for example by giving them legitimacy and/or a regulatory privilege vis-à-vis nonempowered competitors.

From the perspective of principal-agent theory, the extent of the initial delegation of authority is a major determinant of the intermediary's postdelegation power (Mattli and Büthe 2005). With regard to private regulatory intermediaries and CRAs more specifically, the extent of delegated authority may vary depending on: the number and significance of public regulations that reference credit ratings, the range of targets of ratings-dependent regulation, the scope of regulatory purposes and functions outsourced to CRAs, and the more or less compulsory character that (obtaining) a certain rating may have for targets. But principal-agent theory holds that, no matter their extent, delegations of power are revocable: intermediaries can be reined in and disempowered by the regulators.

Principal-agent theory underestimates the autonomy of private intermediaries and overestimates the ability of state principals to discipline them through a mix of carrots and sticks (Mattli and Büthe 2005). Public recognition and empowerment (i.e. delegation) put private intermediaries "in authority," providing an important source of power. By contrast, social recognition of private actors as "an authority" may be boosted by public endorsement, but is not wholly contingent on it. Many private governance actors are private authorities not only by the grace of the state, but also due to their own sources of authority (such as specific knowledge, expertise, or representational skills) and also to coercive structural power.

What is important is that the capacities and power resources of (potential) intermediaries significantly shape the attractiveness of delegating to them in the first place; at the same time, they also render private intermediaries autonomous and resilient toward states' (later) attempts to control them and circumscribe their behavior. Private intermediaries, in particular, may not depend on resources provided by the regulator, and neither their economic viability nor their political power need be solely based on delegated authority (Mattli and Büthe 2005, 403–5). As highlighted by recent research on "orchestration" as a horizontal, soft mode of indirect governance (Abbott et al. 2015), relationships between public regulators and private intermediaries that possess considerable resources of their own may be considerably less hierarchical and characterized by different problems and mechanisms of control than principal-agent models assume.

We would expect that the greater the autonomous resources of private intermediaries, and the stronger their genuinely private sources of power, the less hierarchical will be the relationship between public regulators and private intermediaries, and the more difficult it will be for regulators to maintain or regain control over them. As a result, the (threat of) rescission of authority will be less consequential for intermediaries' actual power.

Path-dependencies and public disempowerment

Both principal-agent and private authority theories offer comparative statics views of the development of RIT schemes. But as proponents of historical institutionalism have long pointed out, institutional reproduction and change occur in a path-dependent manner: previous institutional choices impact regulators' range

of viable choices in the future (Mahoney 2000; Pierson 2000). Past regulatory choices—which have empowered private intermediaries and institutionalized their position in a governance structure—narrow future paths for their disempowerment. Later disempowerment, even in the form of (re-)internalizing privatized governance tasks (i.e., a return to RT regulation), is not impossible; but it becomes more costly, more difficult, and less consequential in terms of curbing intermediaries' actual power vis-à-vis targets. Principal-agent and private authority variables shape the strength of path-dependence: The more extensive the initial delegation, the more private sources of power the intermediaries possess and bring into the R-I-T arrangement; and the more prolonged the regulatory reliance on private intermediaries, the more pronounced will be the material and ideational dynamics of path-dependence.

Continued and large-scale reliance of regulators on the capacities of intermediaries generates significant *material path-dependencies* in terms of progressively growing resource dependence and increasing returns from continued enlistment of the intermediaries. The more limited the capacities of regulators to internalize previously outsourced functions and the greater their dependence on the governance resources of the intermediary (such as expertise, access to targets, credibility, or material means), the more constrained regulators will be in disempowering incumbent intermediaries.

Regulators' resource dependence is determined by two dimensions: the essentiality and the substitutability of the resources controlled by the intermediary (Kruck 2011, 97–98; Pfeffer and Salancik 2003, 46–51). Essentiality describes the extent to which regulators require the resources controlled by the intermediary to attain their regulatory goals. Substitutability denotes the extent to which resources provided by the intermediary can be replaced from other—intermediary or "in-house"—sources (see Mattli and Seddon 2015). A high degree of resource dependence exists when the resources demanded by a regulator and controlled by a particular intermediary are characterized by high essentiality and low substitutability. Under these circumstances, radical rescission to disempower incumbent intermediaries will be unlikely.

The key point of the material path-dependence mechanism is that gaps in regulators' capacity to (re-)internalize governance functions and their dependencies on the resources of incumbent intermediaries tend to progressively grow as intermediary engagement endures and becomes extensive, with this dependence representing one of the "darker sides of intermediation," as van der Heijen (this volume) puts it. Long-term and extensive reliance on particular resource-strong intermediaries predisposes regulators (and depending on the regulatory roles of the intermediary, also targets) to neglect the maintenance or buildup of capacities that could readily substitute for intermediary resources. Moreover, regulators may become vested in particular governance tools for which intermediaries' resources are essential. The costs of exiting the path of continued reliance on regulatory intermediaries therefore increase over time, whereas the relative benefits of continued large-scale reliance on intermediaries grow.

High (low) levels of regulators' reliance on intermediaries lead to strong (weak) increasing returns and great (little) dependence on private intermediaries. As a

result, public regulators that have long and extensively relied on private intermediaries will prefer to avoid a radical recentralization of governance tasks. Rather, they will seek to shift tasks and authority to other intermediaries. If the supply of alternative intermediaries is scarce, that is, if incumbent intermediaries are not substitutable by alternative intermediaries, they will focus on reregulation of the incumbent intermediary.

Increasing essentiality and decreasing substitutability of intermediary resources are general trends in public-private RIT schemes. These dynamics will be more or less pronounced depending on properties of the regulator (strong or limited capacity at the outset of the RIT scheme), the market for intermediaries (a small or large number of intermediaries), and problem-situational contexts. With regard to the latter, highly technical environments characterized by uncertainty, complexity, and rapid rates of change create particularly high demands on public regulators trying to keep up with private intermediaries (see Mattli and Büthe 2005; Mattli and Seddon 2015) and nurture their own capacities to internalize outsourced governance functions.

Besides these material dynamics, self-reinforcing ideational normalization and legitimation mechanisms that render transfers of public authority sticky also complicate later disempowerment of private intermediaries. Public authorization of and reliance on private intermediaries generates *ideational path-dependencies* bolstering intermediaries' authoritative status in the eyes of the regulator and/or the target. The more regulatory roles and authority are transferred to intermediaries, the more this fosters the normalization and legitimation of reliance on them, which then turns into a normalized behavior. Public regulatory recognition enhances the private, for example, epistemic authority of intermediaries to a point where it is hard to cut it back by formal regulatory action. This implies that authority shifts are sticky and hard to effectively reverse even if the formal rules of the game are rewritten.

Bringing these propositions of principal-agent, private authority, and historical institutionalist theories together in a dynamic and synthetic framework, the PDPS approach predicts that: *(1) the larger the private intermediary's own sources of power when an indirect governance arrangement is established, (2) the larger the transfer of regulatory authority to the private intermediary, and (3) the longer regulators rely on this intermediary, the more costly and difficult it will be for regulators to disempower the runaway intermediary*. Path-dependent power shifts favoring the intermediary in the RIT arrangement will then be extensive.

The Empowerment of CRAs as Intermediaries

CRAs are powerful and controversial governance actors (Kerwer 2005; Sinclair 2005). Conceiving them as regulatory intermediaries within the RIT framework helps us to better understand why. Both the properties of CRAs themselves and the effects of public empowerment affect governance outcomes.

The properties of CRAs

CRAs are private firms that estimate and rate the credit-worthiness of borrowers—such as firms, insurance companies, banks, municipalities, and sovereign states—and financial instruments—including bonds, loans, and structured finance products such as collateralized debt obligations (Cutler, Haufler, and Porter 1999, 10–11). CRAs collect dispersed information on the financial situation of borrowers and the default risk of financial products and condense it into a single measure of relative credit risk—a credit rating in the form of a letter grade. These credit risk assessments are published and used widely for making investment decisions (Cantor and Packer 1994, 1).

As commercial firms, CRAs have no inherent concern for the collective good of financial stability, let alone for effective financial market regulation. Credit rating is first of all a business with high profit margins. The credit rating and risk advisory branches of Moody's reported total revenues of $3.5 billion in 2015, with profits (net income) well beyond $900 million. Even in the (post-)crisis years, Moody's experienced impressive growth rates—in 2008 its total revenues were "only" $1.8 billion (White 2010, 216).

CRAs' business model shapes their behavior as intermediaries and compromises the effectiveness and integrity of ratings-based financial regulation. Around 80 to 95 percent of CRAs' overall income stems from fees for "solicited" ratings. Since the 1970s, issuers, that is, borrowers, rather than investors have paid CRAs for solicited ratings. This issuer pays business model shapes **R → I → T** relationships in ways that are undesirable for R, since it contributes to a conflict of interest and a problematic closeness of I to T rather than to R (see also Galland; Loconto; Lytton, this volume). Because issuers pay for their services, CRAs have been overly responsive to targets, leading to "rating grade inflation." In the run-up to the financial crisis, CRAs were happy to be captured by issuers, that is, their clients and targets (Brunnermeier et al. 2009; Hill 2011). This "capture via the intermediary" (see Abbott, Levi-Faur, and Snidal, this volume) contributed to flawed ratings, costly governance failures, and alienation from R's interests, turning CRAs into dysfunctional and unaccountable "runaway" intermediaries.

CRAs themselves argue that their business viability is contingent on their reputation for quality, expertise, objectivity, and independence. This inhibits them from giving inappropriately lenient grades to their clients. However, the validity of this reputational asset argument depends—along with factors such as transparency of rating methods and data, legal accountability, and business model—on competition among multiple intermediaries in the rating industry, a condition that has been absent in real rating markets. Competition has been further undermined by the empowerment of CRAs as regulatory intermediaries, since regulatory recognition has primarily benefitted the incumbent big players. Moody's, S&P, and Fitch (the Big Three) have a combined global market share in credit ratings of 95 percent (White 2010, 216–17).

Complicating matters further, it is not clear that increasing the number of eligible intermediaries, that is, shoring up competition in the rating market, would actually discipline CRAs against capture and increase the quality of ratings. As the targets pay

CRAs, greater competition might even increase incentives to please clients, driving CRAs into even worse behavior in a race to the bottom (Darbellay 2013; Hill 2011; see Abbott, Levi-Faur, and Snidal, this volume). At any rate, proclaiming that the market should and will discipline CRAs, while undermining market competition by regulatory empowerment (and arguably postcrisis reregulation; see below), is not a sound or consistent strategy for regulators.

Enlisting CRAs as intermediaries

Although the goals and interests of public regulators and private CRAs differ substantially, regulators have found it expedient to harness CRAs' risk assessment activities for a variety of regulatory purposes. These include imposing risk-sensitive investment restrictions on financial institutions, defining differential disclosure requirements, and adjusting capital reserve requirements to credit risk exposures (Kerwer 2005, 463; Sinclair 2005, 42–45). Regulatory use of credit ratings constitutes CRAs as regulatory intermediaries (I) fulfilling risk-assessment functions on behalf of public regulators (R), allowing the latter to impose risk-sensitive, ratings-dependent requirements on financial market actors (T):

R (e. g., SEC, BCBS, EU[3]) → **I** (recognized CRAs) → **T** (banks, institutional investors, insurers)

CRAs as intermediaries affect the behavior of targets by (co-)defining a standard of credit-worthiness and measuring compliance with it, thus determining the level of regulatory burden (Kerwer 2005). Rather than designing uniform risk-insensitive regulations or assessing credit risk themselves (both **R** → **T**), or even leaving risk assessment to targets (**R** → **I** = **T**), regulators implicitly transfer the task of risk assessment to CRAs. Although they do not explicitly require CRAs to conduct governance activities that they would otherwise not undertake, public regulators expect CRAs to act on their behalf *as if* they had explicitly ordered them to do so. In a politically naïve view, regulators simply take a free ride by using rating services that CRAs would provide in any case. As elaborated below, however, enlisting selected CRAs (called in the United States "nationally recognized statistical rating organizations" or NRSROs) as regulatory intermediaries has profound impacts on their behavior and power.

The risk-assessment activities of CRAs and the regulatory use of credit ratings contribute to the *implementation* of regulatory policies: general rules about, say, differential capital requirements for different levels of credit risk exposure are clarified and specified through the assignment of specific credit risk ratings, which result in the calculation of a target-specific, temporally variable amount of required capital reserves. CRAs are also engaged in *monitoring* targets' performance in terms of credit risk exposure and risk management even though the "issuer (target) pays" business model of CRAs raises well-founded doubts about the credibility and reliability of CRAs as monitors (Brunnermeier et al. 2009; Hill 2011).

The main reason for regulators to rely on CRAs as intermediaries has been CRAs' operational resources and expertise in the measurement of credit risk

(Kruck 2011). Regulators considered these resources increasingly essential for adequate (i.e., risk-sensitive) financial regulation under the uncertain and volatile conditions of globalization and liberalization; at the same time, regulators have lacked these capacities and found them costly to develop. Reliance on credit ratings from CRAs offered a cost-effective and convenient way to continually adapt the regulatory requirements imposed on financial market actors to their current exposure to credit risk, measured in terms of credit ratings (Bruner and Abdelal 2005, 192–93; Pagliari 2012, 48).

Ratings-based regulation in the United States dates back to 1930s' New Deal regulations. However, only in the 1970s did ratings-dependent regulations become wide-spread. The breakdown of the Bretton Woods system of fixed exchange rates (1973) and the ensuing deregulation and globalization of financial markets led to an exponential increase in the volume of transnational flows of capital. This contributed to the rise of new market actor constellations, financial products, and processes that increased the complexity, volatility, and systemic uncertainty of financial markets. As a result, in the decades until the global financial crisis, regulators became increasingly reliant on CRAs' operational resources and expertise. The number and scope of U.S. regulations that referenced CRAs increased significantly.

By the onset of the crisis, credit ratings were of central importance to financial market actors in all sectors, including banks, insurers, pension funds, mutual funds, broker-dealers, and others. In 2004, at least eight federal statutes and some fifty federal regulations, along with more than one hundred U.S. state laws and regulations, referenced CRAs' ratings as a benchmark in financial regulation. Delegation of regulatory authority was thus extensive, because regulatory use of credit ratings occurred in a large absolute number of rules; affected diverse financial market actors in securities, banking, and insurance markets; was employed for multiple regulatory purposes; and implied numerous compulsory requirements that targets could not otherwise fulfill.

CRAs' operational capacities and expertise are more relevant in liberal market economies such as the United States than in coordinated market economies such as Germany or France, due to differences in the number and diversity of borrowers, the average complexity of the prevalent financial products, and the relative volatility of financial markets (Kruck 2011, 139–44). Nonetheless, in the decades before the crisis, the regulatory use of credit ratings gradually spread around the world (Kerwer 2005; Sinclair 2005, 42–44).

The 2004 Basel II Accord provided for external measurement of credit risk by recognized CRAs as one of two methodologies for determining banks' capital reserve requirements. Sophisticated transnational banks, keen on using their own internal ratings procedures, and industry groups in Europe—especially small and medium-sized enterprises (SMEs), which feared heightened financing costs and competitive disadvantage—vehemently lobbied against an extensive regulatory role for CRAs (Lall 2012). As a result, Basel II provided that banks could, upon application, use their own internal rating procedures.

This development underlines how functional drivers of regulatory use were conditioned by the preferences and lobbying pressure of potential targets, such as transnational banks, and broader affected constituencies (i.e., losers from the

regulatory use of credit ratings such as European SMEs). These political pressures played a noteworthy part in shaping the extent to which regulators eventually relied on CRAs.

How regulatory use empowered CRAs

The "hard-wiring" of credit ratings into financial regulation has both boosted CRAs' private sources of power and conferred regulatory authority to CRAs. It had both direct (delegating) and indirect (endorsing and supporting) effects, amounting to the public empowerment of CRAs as regulatory intermediaries.

CRAs are not just commercial information providers, but governance actors capable of wielding authority (Cutler, Haufler, and Porter 1999; Sinclair 2005). By defining and monitoring criteria of credit risk for investors and borrowers around the world, CRAs have established a nearly global private standard of credit-worthiness.

This standard is first of all backed by CRAs' own expert authority and legitimacy in the eyes of financial market actors (Nölke 2004, 163–64). Because of CRAs' presumed expert status, investors rely extensively on credit ratings for screening nontransparent capital markets. Borrowers are aware of CRAs' published criteria for credit-risk assessment and adjust their behavior to those criteria, as ratings are vital for borrowers' financing conditions and access to capital. Both investors and borrowers are dependent on CRAs—for analytical resources and credibility, respectively—leading them to recognize CRAs as private authorities. In sum, CRAs begin with genuinely private, state-independent power: epistemic authority, enhanced by the "moral authority of the non-state, non-self-interested referee" (Bruner and Abdelal 2005, 191; Porter 2010, 59), and the resulting structural power as gate-keepers of global financial markets. These are important sources of power: even without delegated public authority, they might have been sufficient to give CRAs an influential role in governing disintermediated financial markets.

Nonetheless, public regulatory empowerment provides a second major source of CRAs' power, which not only builds on but interacts with and multiplies CRAs' independent power. When financial regulations rely on credit ratings, they reinforce the authority and the perceived reliability and legitimacy of CRAs. Regulatory use not only reflects the market norm and practice of relying on CRAs, it also promotes the entrenchment of credit ratings in market practices.

As public regulators have come to realize, the regulatory use of credit ratings signals to investors that it is safe to rely on CRAs' risk assessments: if private credit ratings are deemed sufficiently reliable for regulatory purposes, they should also be adequate for making investment decisions. Moreover, the regulatory use of credit ratings has a direct effect on CRAs' power. The public regulator makes CRAs' private standard of credit-worthiness legally binding; compliance with the standard becomes mandatory (Kerwer 2005; Nölke 2004). Thus, "ratings are given the force of law" (Bruner and Abdelal 2005, 191).

This delegation entrenches the structural power position of the few recognized, incumbent CRAs as gatekeepers. It renders ratings more valuable in the financial

system and provides a lucrative boost to CRAs' business (Bruner and Abdelal 2005, 193; Darbellay 2013, 45). It may also attenuate reputational pressures to ensure high informational quality and credibility, since, at the extreme, the business of recognized CRAs shifts from providing credit information to selling "regulatory licenses" (Partnoy 2009) that issuers have to buy. Finally, regulatory use damages competition: it creates regulatory barriers to entry and reinforces an effective oligopoly of recognized and regulation-eligible market incumbents.

Postcrisis Reform Efforts and the Persistent Power of CRAs

CRAs contributed to the emergence and spread of the global financial crisis by greatly underestimating the credit risk of "toxic" structured finance products such as mortgage-backed collateralized debt obligations (Porter 2010, 69; Brunnermeier et al. 2009, 54). This "rating fiasco" (Kruck 2016) highlighted underlying structural pathologies, including persistent flaws and a lack of transparency in rating methodologies and models, little legal accountability for ratings, an oligopolistic market structure, and especially the conflicts of interest and collusive behavior between CRAs and issuers (targets) that resulted from CRAs' issuer-pays business model.

Regulators—including both elected legislators and nonelected federal agencies such as the SEC—came to view extensive regulatory recognition as a mistake because it contributed to investors' overreliance on CRAs (then-SEC chairman Cox in Ackermann 2008; see Darbellay 2013, 59; Pagliari 2012, 57). Moreover, as governments used taxpayer money to bail out financial institutions, financial regulatory politics became highly politicized; it became politically imperative for elected policy-makers to visibly disempower one of the main culprits of the financial turmoil (Pagliari 2012, 52). Despite their frustration with CRAs, however, regulatory agencies—aware of the costs and complications of conducting risk-sensitive regulation without CRAs—were more hesitant to propose sweeping disempowerment. Legislators effectively overruled their concerns in the 2010 Dodd-Frank Act; but the impracticality of radically moving away from credit ratings became obvious as federal agencies struggled mightily to implement the relevant provisions of the Dodd-Frank Act.

Efforts to reduce regulatory reliance on CRAs

The SEC first issued several interrelated rules in 2009 to remove references to NRSROs from a number of securities regulations (Ackermann 2008; Pagliari 2012, 57). But initially, no other federal agency followed suit. Even the SEC appeared inconsistent in its approach: in 2010, it also proposed regulations that would increase money market mutual funds' reliance on ratings (White 2010, 224). Federal agencies still hesitated to fully renounce the regulatory use of credit ratings because they had neither external alternatives ready nor

the "in-house" capacities to perform credit risk assessment. In early 2010, approximately 2,000 references to credit ratings could still be found in the U.S. Federal Register (Darbellay 2013, 60). Against this backdrop and due to growing public pressure, elected legislators took the regulatory initiative.

The resulting 2010 Dodd-Frank Act aimed at eliminating regulatory reliance on CRAs. It expressly removed statutory references to ratings. Moreover, it required every federal agency to review how existing agency regulations (where most references to CRAs could be found) relied on ratings. Federal regulators were then to remove regulatory reliance on ratings and replace them with alternative criteria within one year (Darbellay 2013, 61; European Commission 2013, 3; SEC 2017). These provisions affected a broad range of regulators and targets in securities, banking, and insurance regulation, as the regulators for all major financial markets heavily relied on credit ratings.

Regulators had to look for substitutes, but these were hard to find. The relevant provisions of the Dodd-Frank Act proved more difficult to implement than expected, and regulators soon delayed the implementation deadline. The SEC eventually managed to remove several sets of references to credit ratings in rules adopted in 2011 and 2013. But a substantial number of SEC rules remained unmodified, and other regulatory agencies also struggled to implement the Dodd-Frank requirements in consequential ways. As of the end of 2016, only a minority of CRA-related requirements spelled out in the Dodd-Frank Act had effectively been implemented by the competent regulators (SEC 2012, 2017).

Costs and complications of reducing reliance on CRAs

Implementation of the Dodd-Frank provisions was so difficult because, after decades of extensive use of credit ratings, regulators had become dependent on CRAs. Over time, relying heavily on CRAs' resources for risk-sensitive regulation, regulators had failed to nurture ready and affordable substitutes (Darbellay 2013, 86; Hill 2011). As a result of these strong material path-dependencies, the costs of leaving the entrenched path of regulatory reliance and radically displacing the incumbent intermediaries were very high.

One way to eliminate references to credit ratings would be to renounce risk-sensitive regulations altogether. But regulators viewed it as imperative to stick with regulations that were contingent on targets' exposure to credit risk and that adjusted to changing market circumstances. Uniform, non-risk-weighted regulatory requirements such as the Basel I capital reserve provisions had effectively encouraged riskier investments by banks to increase their returns on regulatory capital (Pagliari 2012, 48–49). The Federal Reserve Board warned that "section 939A [of the Dodd-Frank Act] could reduce the risk sensitivity of bank risk-based capital ratios if risk weights become more uniform by asset class because workable alternatives cannot be found or are too costly" (Federal Reserve Board 2011, 3). The board continued to advocate risk-sensitive regulation to discourage investors from taking on riskier assets, arguing that alternative measures of credit risk would have to reflect market developments quickly, adjust to new information, and may not increase the risk of regulatory arbitrage. Regulators also agreed that

references to credit spreads as a market-based substitute for credit ratings would only boost procyclical effects.

Where they have adopted an alternative to external credit ratings, U.S. regulators have often enhanced the regulatory roles of banks and institutional investors. Regulators replaced a number of references to CRAs with regulatory recognition of banks' internal rating procedures (e.g., to define risk-weighted capital requirements). In doing so, regulators passed the task of credit risk assessment to other private intermediaries (banks' internal rating units), which are subunits of the regulated targets (banks). This mode of governance might be represented as **R** → **I** = **T** or **R** → **t** → **T** where t ∈ T (see Abbott, Levi-Faur, and Snidal; Havinga and Verbruggen, this volume). Evidently, a shift from reliance on external ratings by CRAs to internal ratings by banks does not entail a stronger positive role for the state.

However, this shift of intermediaries might make matters even worse in two ways. First, the internal rating-based approach would create significant difficulties and costs for smaller, less sophisticated banks (Lall 2012, 630). Both regulators and banks themselves expressed doubts about whether smaller financial institutions could do a better job of analyzing securities through internal ratings than CRAs did (Federal Reserve Board 2011, 4; Hill 2011, 144). Second, policymakers feared moral hazard of banks using exclusively internal ratings. As a result, regulators often refrained from fully replacing external credit ratings by CRAs with internal ratings by banks.

A shift to a direct **R** → **T** approach, in which regulators would produce risk assessments themselves, was not considered a serious option. This would have implied a government takeover of the credit rating business, with entities equivalent to Moody's or S&P's replaced by a government agency. The (few) proposals pointing in this direction drew strong opposition from virtually all parts of the financial policy community. The main concerns were the high costs of setting up a public CRA, as well as the lack of in-house rating expertise and capacity within existing government agencies. The Fed bluntly argued that alternatives to credit ratings should "incorporate market participants'" views rather than only the supervisor's view of creditworthiness. "Supervisors generally do not have the resources independently to rate the creditworthiness of individual assets on a regular basis across hundreds of regulated institutions" (Federal Reserve Board 2011, 4). Moreover, the quality and credibility of ratings might suffer even more if they were issued by a state-run entity that lacked political independence.

Tellingly, the difficulties in the United States in implementing Dodd-Frank strongly informed the 2013 EU credit rating agency regulation (Kruck 2016). The EU was explicit that EU regulators did not want to rush a withdrawal of credit ratings from financial regulation, as the "experience in the U.S. has shown that it is difficult to remove references to ratings without having viable alternatives in place" (European Commission 2013, 11).

Limited effectiveness of rescinding delegated authority

Even if these issues were transitional problems that could be resolved in the medium-term, significant barriers to the public disempowerment of CRAs would

still remain. Rescission of CRAs' delegated authority would not only be costly and complicated. It would also have only a limited effect on CRAs' de facto power. Again, the PDPS approach helps us to understand why this is so.

First, even after severe mistakes, CRAs possess their own private sources of profit, structural power, and expert authority, as they have never been fully dependent on regulatory recognition. They benefit from market actors' sustained, albeit grudging, recognition that it is hard to do business in current securities markets without CRAs' assessments. Moreover, issuers continue to depend on ratings for access to the capital markets and viable financing conditions. And the level of competition among CRAs is still low. These factors limit the leverage regulators have over their intermediaries: their relationship is characterized by a low degree of hierarchy and CRAs' power is pretty resilient to states' rescission of delegated authority.

There is a second related complication—the sticky effects of public empowerment on CRAs' power over market actors. CRAs not only continue to possess their own substantial sources of power and profit that predate public empowerment, extensive regulatory use has contributed to deepening and widening the historical embeddedness of CRAs in now deeply entrenched market practices. The key point here is that regulatory recognition did not just grant CRAs a certain amount of authority that can easily be deducted again; rather, it helped multiply CRAs' power. Imagine that the use of credit ratings for a particular regulatory purpose entailed the transfer of ten units of power to CRAs. Say 25 years later, CRAs have used these ten units in interaction with their own sources of power to amass one hundred additional units of power. Rescinding the initially delegated ten units will hardly harm CRAs' power now. To put it differently, CRAs have profited from the regulatory privilege that they enjoyed for decades to increase their state-independent power in financial markets and their resilience to (threats) of rescission. How did that occur?

On one hand, regulatory use of credit ratings has promoted market actors' dependence on CRAs' analytical and operational resources and on their judgments over access to capital markets. It has helped to put CRAs into a powerful structural position as indispensable experts and oligopolistic gate-keepers. Once entrenched, this dependence of targets and the structural power of CRAs will likely persist even if ratings-dependent regulations are withdrawn.

But to fully appreciate the stickiness of public empowerment, we need to go beyond material-structural effects to include ideational dynamics. Boosted by regulatory recognition, CRAs have consolidated their status as authoritative experts that frame understandings of risk measurement and management. Over time, investors' reliance on CRAs' risk assessments has turned into normalized behavior: "over the past decades behavioral reliance has added to regulatory reliance" (Darbellay 2013, 86; see Partnoy 2009, 10). Even when severe rating mistakes should have been fresh on investors' minds, they have continued to rely on CRAs. As long as investors do so, rather than demanding that issuers go elsewhere for verification of their credit-worthiness, issuers too will be dependent on CRAs' judgment (Hill 2011). Even after the financial crisis, CRAs' position as authoritative judges of credit-worthiness is largely intact in the eyes of market

participants. After a strong dip in 2008, market shares and profit margins of the leading CRAs have risen again. Their assessments are still widely seen as consequential; therefore, they must be taken into account when devising business strategies and financial policies.

Bankers and brokers themselves claim that market norms dictating the use of CRAs are sticky regardless of bad rating performance: "You basically have to go to Moody's and S&P. …The market doesn't accept it if you don't go to both of them" (Dessa Bokides quoted in Hill 2011, 140). Market actors believe that they must continue to rely on the most prominent CRAs because other market participants are still doing so. These sticky beliefs, which amount to a collective self-fulfilling prophecy, have contributed to the persistence of an oligopoly of failing, but still powerful CRAs. The market practice of relying on credit ratings is unlikely to disappear any time soon, even if formal regulatory references to credit ratings are removed (Partnoy 2009, 10). U.S. regulators have self-consciously admitted that, even without regulatory prescriptions, "as a practical matter … the large number of broker-dealers will continue to make use of NRSRO ratings. But they need not" (Sirri quoted in Ackerman 2008).[4]

Incremental reregulation of CRAs and its inadvertent effects

For all these reasons, regulators have been left with only one major alternative: incremental reregulation and shored-up oversight of CRAs. The Dodd-Frank Act introduced a mandatory registration system, endowing the SEC with enhanced oversight and monitoring competencies. It also provided for stronger procedures by CRAs to deal with conflicts of interest; more independence in CRAs' corporate governance; greater internal controls; and more extensive disclosure of data and assumptions underlying credit ratings, rating methodologies, and performance statistics (Hill 2011, 144). The SEC was further charged with prescribing standard requirements regarding rating procedures and methodologies (Darbellay 2013, 71). Finally, Dodd-Frank introduced an enhanced legal liability regime for CRAs. The EU adopted similar, or even more intrusive, rules in three regulations (2009, 2011, 2013).

While these rules may indeed constrain CRAs' behavior, reregulation will not fundamentally curb the power of incumbent CRAs (Hill 2011). They may even have the opposite effect by entrenching CRAs' status as private authorities, working at cross-purposes with the declared aim to reduce CRAs' centrality (Kruck 2016). Postcrisis regulation has failed to address the core conflict of interest arising from payment of CRAs by issuers. Intrusive regulation may also create regulatory barriers to entry by new CRAs, with negative effects on competition in the rating market (White 2010, 224).

Finally, reregulation inadvertently validates, rather than downgrades, CRAs' status as important governance actors, rather than mere purveyors of opinions or mundane providers of services. It institutionally inscribes CRAs as flawed but indispensable gatekeepers that must (and can) be regulated and controlled to "function properly" and fulfil a systemic oversight function in financial markets. This is a high, if not delusional, regulatory ambition. Rather than reducing CRAs'

centrality, shored-up regulation may encourage further overreliance on a small number of incumbent CRAs, as it gives "too much of an official endorsement to ratings" (Brunnermeier et al. 2009, 54) and reassures market actors of CRAs' seeming trust-worthiness (Darbellay 2013, 86–87).

Conclusion: PDPS and the Intermediary Selection Dilemma

The above PDPS account of the crucial empowerment and the futile disempowerment of CRAs underlines that research that focuses solely on the extent of a delegation (principal-agent), or on the autonomous resources of an intermediary (private authority), or on the role of history and network effects (historical institutionalism) may miss important sequential and interactive relationships among these variables. Studying the interaction of these variables, rather than trying to isolate their individual importance, produces a comprehensive understanding of shifting power in RIT settings. This is all the more relevant because endogenous shifts of power among regulators, intermediaries, and targets over time, as well as material and ideational path-dependencies leading to a fundamental asymmetry in the empowerment and disempowerment of private intermediaries, can be expected to characterize many other indirect governance arrangements beyond the specific case of CRAs.

An important implication of the PDPS argument is that regulators regularly face an "intermediary selection dilemma": they will often have incentives to pick resource-strong intermediaries, which are recognized authorities and dispose of substantial material or immaterial capabilities. Acquiring capacities that regulators need but do not possess themselves will often be the very rationale for enlisting a particular intermediary. But regulators must also anticipate the negative effects that the choice of a strong and authoritative intermediary may have on later attempts to control that intermediary when the preferences of regulator and intermediary diverge.

Autonomous intermediary resources complicate (hierarchical) control. They render the relationship between regulators and intermediaries more horizontal than principal-agent models assume, limit the regulator's influence on the intermediary in an orchestration setting, and may induce the regulator to rely so heavily on the intermediary that the regulator's direct regulatory capacity is diminished over time. A dynamic conception of $\mathbf{R} \rightarrow \mathbf{I} \rightarrow \mathbf{T}$ relations helps us to understand how extensive and prolonged empowerment of an intermediary exacerbates the control problem: it allows the intermediary not only to preserve but also to expand its (power) resources, even as the regulator's ability to displace the intermediary is shrinking. Further comparative research testing the PDPS approach and focusing on different issue areas and intermediaries is clearly warranted to study how regulators deal with these dynamics and with the intermediary selection dilemma.

Notes

1. *Authority* refers to recognized power (Zürn, Binder, and Ecker-Ehrhardt 2012). It denotes a particular type of power that is (at least in part) based on addressees' recognizing that an actor can make competent judgments and binding decisions rather than on mere structural asymmetries or coercion. I use the term *authority* to emphasize the presence of an element of "recognition." Otherwise, the more generic term *power* is used.

2. The gist of the PDPS argument should also apply beyond private intermediaries. However, as highlighted by researchers of private authority and in the relevant section of this article, RIT schemes with private intermediaries may be particularly likely to display path-dependent power shifts in favor of the intermediary, which is why my argument focuses on them.

3. SEC = U.S. Securities and Exchange Commission, BCBS = Basel Committee on Banking Supervision, EU = European Union.

4. Dessa Bokides is a high-level U.S. broker and banker. Eric Sirri was director (from 2006 to 2009) of the Division of Trading and Markets at the SEC, where he was responsible, among other things, for matters relating to CRAs.

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