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I. INTRODUCTION

One of the most important issues in finance and, more specifically, in corporate finance, is the informational problems that plague financial contracting relationships—what information does each party need to know. A sizeable part of the literature on this topic concerns possible mechanisms developed to face these problems—including the best candidates to manage this information, as well as disclosure requirements, different incentive structures, and incentives for information gathering.

It is logical that comparative advantages in collecting information should lead to the emergence of institutions specialized in collecting information on corporate solvency, which then distribute this information in a way easily understood by prospective investors. Among the most important players in this arena, at least in developed financial markets, are the credit rating agencies—institutions that have, as their main objectives, to evaluate the capacity of different debtors to repay funds and provide this information to prospective lenders.

However, in both developed and developing markets, the current industry structure for credit rating agencies is more the result of the interplay of market forces and regulatory fiat than one naturally derived from comparative advantages. This interplay also drives the nature of competition between such entities. The present article provides an example of this thesis, by focusing on the competition between credit rating agencies in Brazil, and new regulations regarding these institutions.

II. CREDIT RATINGS AGENCIES IN BRAZIL

By contrast with the United States, where credit rating agencies were already strong in the early twentieth century, credit rating agencies only became important in Brazil in the nineties. The first important operation in which rating agencies were involved was in 1994, when the Brazilian rating agency SR Rating issued a rating for a structured operation involving receivables from Grupo Mesbla.

In the following year, a second domestic rating agency, Atlantic Capital, started its activities, focusing on the banking market. Only in 1996 did the international rating agencies began to enter the Brazilian market, with the association of Duff & Phelps and SR Ratings. In 1997 Standard & Poor's and the French IBCA also entered.

The next phase in the market's evolution began in 2003, with the acquisition of Atlantic Rating by Fitch Ratings. At this time, for merger reviews, revenue-based market shares broke

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down as follows: 20 percent to Fitch Brasil (resulting from the merger of Atlantic Rating and Fitch), 62.74 percent to Standard & Poor's, 9.78% to Moody's, and 3.12% to SR Rating. Since then, the largest market shares have been held by the U.S. rating companies.

Currently, the active companies in this market are the three major international companies—S&P, Fitch, and Moody's, as well as four domestic ones—SR Rating, LF Rating, Austin, and the recently created Liberum. LF Rating was founded in 2002, and Austin dates from the nineties.

To date, the industry has faced only one credibility problem, with the failure of the Santos Bank in 2004. Santos had a policy to hire only those rating agencies that gave positive ratings to its securities and over-all financial solvency. Any rating company that gave a negative rating to the bank had its relationship with the institution terminated. As a result, only two months before Santos Bank failure, Austin Rating issued a rating of "A" to Santos, stating the bank was solid and low risk. This problem prompted some discussions on the quality of the ratings issued in Brazil, but no regulatory action was taken until 2012.

III. REGULATIONS AND REQUIREMENTS FOR RATINGS

The Brazilian case is especially interesting as far as regulations are concerned, especially concerning requirements for ratings:

- Ratings are mandatory for securitization operations, especially those involving agricultural receivables and those structured as FIDC.[2]
- The Brazilian Central Bank, on the other hand, does not use ratings in determining prudential regulation guidelines for the domestic banking industry, but relies on each bank's own risk assessment for determining regulatory capital requirements. On the other hand, the same Brazilian Central Bank does rely on foreign ratings when choosing foreign assets and financial institutions.
- The Brazilian pension fund regulator requires that all pension funds (public and private) be required to take into account ratings in assessing their portfolio risks. Public pension funds are also required to invest a share of their portfolio in rated securities.
- As for the insurance market, the reinsurance companies have to have a rating of their solvency, in accordance to the guidelines of the Brazilian Insurance Regulator ("SUSEP").
- Regarding commercial relationships between rating agencies and their customers, requirements seem to conform with what is observed in other markets: the issuer contacts the rating agencies to ask for a grade concerning its ability to honor its commitments. The agencies can also issue unsolicited ratings, which are usually based on publicly available information. There are no exclusivity requirements—that is, companies are not required to use ratings from only one agency, and it is common for companies to ask for ratings from more than one agency. Solicited ratings can be made public or not, by agreement

[2] FIDC – In Portuguese, *Fundo de Investimento em Direitos Creditórios* – loosely translated as Investment Fund in Creditors' Rights. The FIDC funds itself by issuing bonds whose returns are related to the underlying assets.

between the rating agency and its customer. Major customers are banks, investment companies, asset management companies, as well as the issuers mentioned above.

Even though these requirements have created a sizeable demand for ratings, until there was no formal regulation on which companies were allowed to issue those ratings. That is, until 2012 the major barrier to entry was the reputational capital required to attract customers.

IV. A NEW FOCUS ON THE RATING AGENCIES

Instruction 521 of the Brazilian Securities and Exchange Regulator (*Comissão de Valores Mobiliarios* in Portuguese) has greatly changed the barriers to entry in this market, and therefore strongly affected the players. This instruction requires all rating agencies to be registered with the Brazilian regulator. Foreign rating agencies are also required to be registered with their home country regulators, provided there is a bilateral agreement with the Brazilian regulator or their home country is signatory of the multilateral memorandum of agreement of IOSCO. Those who do not comply with this regulation are subject to a daily fine of 500BRL.

Besides authorizing the operation of rating companies in Brazil, the Brazilian regulator now requires rating agencies to have a code of practice addressing the issues of:

- information sources to be used in the ratings;
- monitoring and timely update of ratings—except when they are clearly stated not to be updated;
- independence of the company and of their analysts with regard to any issued rating;
- potential conflicts of interest,
- the commercial relationships between the agency and their customers; and
- trading behavior in securities by the analysts of the rating agency.

And there are additional rules:

1. Whenever an analyst leaves a rating agency to work for a company which has been rated by that analyst, all work carried out by this professional in the previous two years must be subjected to a review.
2. Any ratings announcement must stress all potential conflicts of interest; for example, when the revenue from any one given rating is a significant share of overall revenue.
3. There must be a structural separation between the rating agency activity and any others conducted by the same company, such as consulting.
4. General further constraints on what is considered as acceptable behavior by the rating analysts, in addition to those of the code of conduct.

As for the international compatibility of such norms, on April 27, 2012, the ESMA (European Authority of Exchange and Securities Markets) announced that the Brazilian Regulation is in line with European rules, which implies European financial institutions can continue using ratings issued in Brazil for regulatory compliance.

V. CONCLUSIONS

This history and current overview of the industry allow us to draw some conclusions. First, even though there is a quite large demand for ratings as a result of regulatory requirements, the market for rating agencies in Brazil is bound to be smaller than in developed markets, because ratings issued by third-party companies are not allowed to be used by financial institutions to compute regulatory capital requirements.

On the other hand, the demand for such ratings is expected to increase in the next few years, due to an increased access to international financial markets and the associated regulatory requirements (two examples are the Brazilian Central Bank using ratings to choose foreign investments and financial institutions, and the Insurance Companies' regulator evaluating foreign reinsurers). Another source of demand for ratings is the demand for information on investment alternatives. Even though ratings are not required by regulators, they are still being made public by issuers as part of information disclosure.

In terms of potential competitive problems, the mandated registration requirement, together with the need to establish a solid track record, undoubtedly are strong barriers to entry. Furthermore, given the reputation already achieved by existing rating agencies, it is quite unlikely a new entrant could reach an important market share in a short time frame.

However, the likelihood of a major player unilaterally increasing prices is quite low. Since it is quite unusual for a rating agency to request exclusivity from a customer, the agencies seem to compete strongly for customers, increasing customers' bargaining power. Besides, in many situations, ratings are not required by the customers.

All in all, the lower regulatory demand of ratings, coupled with a lightly regulated supply of such ratings until 2013, makes Brazil an interesting case of a rather free market in rating agencies. The results of this experiment have not been an unqualified success, with some failures such as the case of Santos Bank. Future developments arising from the new regulatory framework remain to be seen.