ECONOMIC AND SOCIAL COUNCIL

"The Impact of Credit Rating Agencies on Financing for Sustainable Development"
(ECOSOC Chamber, 8 December 2014, 10 am to 1 pm)

PROGRAMME

Chair: H.E. Mr. Martin Sajdik (Austria), President of ECOSOC
Moderator: Ms. Merli Baroudi, Director and Chief Credit Officer, World Bank Group

Panellists:

Ms. Chee Mee Hu, Managing Director, Project Finance and Infrastructure Group, Moody's Investors Service;

Mr. Thomas Missong, President of the European Association of Credit Rating Agencies;

Mr. Bruno Bertocci, Managing Director and Global Equity Portfolio Manager, UBS Global Asset Management (Americas) Inc.

Professor John Coffee, Columbia Law School;

Interactive Discussion

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Concept Note

1. Background

By providing creditors with information on the creditworthiness of borrowers, credit ratings agencies (CRAs) play an important role in the efficient functioning of capital markets and influence the flow of finance towards countries, companies and projects across the globe. However, the financial crisis highlighted questions about the effectiveness of CRAs in providing accurate and unbiased information, and demonstrated the impact inaccurate ratings can have on the stability of the international financial system.

While credit ratings in the corporate sector have been less controversial, there have been concerns regarding the accuracy of ratings on structured finance and sovereign debt. In light of the forthcoming Third International Conference on Financing Sustainable Development, which will focus on addressing challenges in mobilizing resources for sustainable development, it is important to address these concerns. The ECOSOC meeting will build on the General Assembly Thematic Debate on "The role of Credit Rating Agencies in the International Financial System" that took place on 10 September 2013. That thematic debate provided an opportunity for Member States to exchange views and experiences with the executive heads of major credit rating agencies, senior officials of leading financial institutions and leading international and national experts.

That discussion highlighted several shortcomings in the credit rating industry that became particularly apparent after the 2008 crisis. These include the hard wiring of ratings into regulatory frameworks and excessive reliance of investors on ratings, a high level of industry concentration resulting in lack of competition, low transparency, conflicts of interests due to the issuers' pay model (i.e. issuers pay the agencies to obtain ratings), pro-cyclicality of ratings which have contributed to volatility in the real economy, and the considerable influence which sovereign debt ratings wield on the ability to borrow and to finance development.

Since the crisis steps have been taken to address many of these issues. Governments' responses have been two-fold. A number of countries have carried out reforms, such as the United States, the European Union, Argentina and China. Several initiatives have also been undertaken at the international level, including the Principles for Reducing Reliance on CRAs proposed by the Financial Stability Board and approved by the G20 and the revision of the IOSCO's Code of Conduct for Credit Rating Agencies.

During the thematic debate, several proposals were put forward for consideration, including: the establishment of a global rating platform based on a uniform rating scale; initiatives for investors to better understand the role of ratings and make better use of ratings; specific measures to increase transparency and competition; alternative structures to address conflict of interest; and the establishment of domestic and/or public CRAs. There was also discussion

of the creation of a United Nations Observatory of credit rating service providers, though several speakers expressed caution on this initiative.

The purpose of the meeting is to closely examine practical ideas to propose as inputs to the third International Conference on Financing for Development. These would relate to the issues for consideration outlined in the following section of this note, comprising a) structures to address conflicts of interest, b) measures to increase competition, c) addressing excessive reliance of investors on ratings, d) assessing the methodologies of CRAs, including the possibility of incorporating sustainability considerations into them and e) promoting better global coordination, standards and reach of ratings.

2. Issues for consideration

a) Structures to address conflicts of interest

The remuneration of CRAs changed in the pre-1970s from investors paying for ratings services (investor-pays model) to one where borrowers choose a ratings agency and pay it to assess and rate their securities (issuer-pays model). The change was in part because CRAs considered that the investor-pays model was not sufficiently a sufficiently sustainable business model. However, in the issuer-pays model a borrower has an incentive to choose the CRA it believes might offer the most favourable ratings, which may lead to a conflict of interests that produces an upward bias in ratings.

The official sector has recognized concerns regarding the conflict of interests inherent to the issuer-pays model and some countries have have adopted procedures aimed towards minimizing inappropriate incentives. For example, in 2010, the Dodd-Frank Act in the United States increased the authority of the Securities and Exchange Commission (SEC) to oversee CRAs, and a new office within the SEC was established that initiated measures to strengthen oversight of CRA activities in several areas, including record keeping, reporting requirements (such as performance measure statistics, methodology and written procedures description) and disclosure. In the European Union, the legislative framework on CRAs aims to address conflicts of interest through a wide set of rules concerning: the governance of CRAs, the independence of rating analysts, internal procedures, the services that can be offered by CRAs and shareholding limitations. To mitigate conflicts of interest from important shareholders, the new EU rules introduced in 2013 require CRAs to disclose publicly if a shareholder with 5% or more of the capital or voting rights of the concerned CRA holds 5% or more of a rated entity, and would prohibit a CRA from rating an entity when ownership levels are 10% or more.

The ECOSOC meeting could examine how effective these efforts have been in addressing the issue of conflict of interests. It could also discuss potential alternative measures to address conflict of interests. For example during the 2013 thematic debate, John Coffee (Professor, Columbia Law School) proposed a new structure in which the role of selecting the initial CRA would be given to a representative body of investors, while allowing issuers to seek additional ratings from other CRAs.

b) Measures to increase competition

As emphasized in the 2013 thematic debate, although there are more than 70 CRAs globally, the three largest CRAs (Moody's, Standard and Poor's and Fitch) hold over 90 percent of market share, representing an extremely concentrated market structure. This high degree of concentration can amplify so-called 'cliff effects' when a one or two notch rating change leads to a disproportionately large change in investor behaviour and market prices. It can also generate anti-competitive behaviour by conferring excessive powers to a few entities.

To increase competition, different types of institutions could be encouraged to participate in the business. In the thematic debate, it was pointed out that Argentina's Capital Market Act enabled universities to act as rating agencies, which served to allow greater competition and reduce reliance on CRAs. Regulatory policies have also been introduced in the European Union. In particular, the CRA III Regulation of 2013[1] introduced measures to improve diversity in the rating market by helping small CRAs to build their reputation and become more visible towards investors and issuers (e.g. the obligation for issuers to consider the appointment of a CRA with a market share of less than 10%, when using more than one rating; the establishment of an European rating platform allowing investors to compare all existing ratings with regard to a specific entity/instrument etc).

However, moving to a more competitive structure is not straightforward. It has been argued that there are inherent economies of scale in the provision of information (gathering and analysing information has a high fixed cost) naturally lead to a high degree of market concentration. In addition, issuers may be reluctant to switch to obtain ratings from new market entrants since this may cause suspicion that they are trying to avoid a downgrade or get a more favourable rating. In addition, it has been argued that greater competition may lead to a multiplicity of ratings and incentives for CRAs to offer higher ratings in a bid to be hired. The incentives embedded in the issuer-pays model may reinforce market concentration, and reforms may need to proceed hand-in-hand with measures on conflicts of interest.

The ECOSOC meeting can discuss alternative market structures and policy developments in this area.

c) Addressing excessive reliance of investors on ratings

Given the significant role of CRAs in the financial crisis, there has been an increased awareness of an excessive reliance of investors on ratings. In particular, the mechanistic reliance of certain regulations on ratings is an issue that requires further attention.

In response to the financial crisis, important steps have been taken at international level to reduce reliance on credit ratings, in particular by the FSB, but also by the Basel Committee.
The FSB Principles[2] to reduce reliance on CRA ratings in standards, laws and regulations (endorsed by the G20 Leaders in November 2010) aim to end mechanistic reliance on credit ratings by banks, institutional investors and other market participants and to establish

[1] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, OJ L 146, 31.05.2013.

[2] Principles for Reducing Reliance on CRA Ratings, Financial Stability Board, 27 October 2010, available at: http://www.financialstabilityboard.org/publications/r_101027.pdf

stronger internal credit risk assessment practices as an alternative. They set out broad objectives which standard setters and regulators could follow and identify specific actions to implement over time.

However, at the end of 2011, the FSB observed slow progress of jurisdictions on the implementation of the principles. Consequently, in 2012 the G20 Leaders in their Los Cabos Declaration[3] and the G20 Finance Ministers and Central Bank Governors called for faster progress and the FSB therefore published a Roadmap[4] in October 2012 with timelines to accelerate the implementation of the FSB Principles. The Roadmap recognised that the removal of references to CRA ratings in standards, laws and regulations is a necessary precondition for incentivising market participants to develop their own credit risk assessment capabilities.

In order to accelerate progress on the implementation of the Roadmap, the FSB then undertook a thematic peer review[5] to assist national authorities in fulfilling their commitments under the Roadmap.

The review was structured in two stages:

- the first stage, published in August 2013, comprised a structured stock-taking of references to CRA ratings in national laws and regulations;

- the second and final stage focused on the action plans developed by national authorities to implement the Roadmap[6].

The peer review identified that the main actions to remove credit ratings from legislation have been undertaken in the US, with the adoption of Dodd-Frank Reform Act,[7] and in the EU. The overall framework in the EU to reduce reliance on credit ratings covers a wide range of regulatory measures in a multi-layer approach, covering the CRA III Regulation, sectoral legislation in financial services, actions by European Supervisory Authorities and by the relevant national sectoral authorities.
The peer review also highlighted the need for coordination of the implementation of the principles across all national agencies and bodies within a given jurisdiction, with many jurisdictions pointing to the need for guidance from international standard setters on alternatives measures to credit risk assessment.

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[3] G20 Leaders Declaration, Los Cabos, Mexico, 18-19 June 2012, available at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/131069.pdf .

[4] Roadmap and workshop for reducing reliance on CRA ratings - FSB report to G20 Finance Ministers and Central Bank Governors, 5 November 2012, available at: https://www.financialstabilityboard.org/publications/r_121105b.pdf

[5] Financial Stability Board, Thematic Review of the FSB Principles for Reducing Reliance on CRA Ratings (final), 12 May 2014, . http://www.financialstabilityboard.org/publications/r_140512.htm

[6] The action plan for each national authority can be found at http://www.financialstabilityboard.org/publications/c_140429.htm.

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o)

Reducing mechanistic reliance on rating implies to find viable alternatives. The FSB peer review highlighted that national actions plans shall envisage additional work for the development of alternative measures of creditworthiness and incentivise investors to make their own creditworthiness assessment. However, such an approach needs to be proportionate and take into account the challenges faced by smaller financial institutions with limited resources and capabilities to conduct extensive own credit risk assessments.

In the EU, specific rules have been introduced requiring financial institutions to strengthen their credit risk assessment. In addition, the EU CRAIII Regulation introduced specific transparency measures on structured finance instruments (SFIs), in order to enable investors to make their own creditworthiness assessment of these instruments[8].

Existing efforts at international and national level need to be reviewed and discussed with a view to ascertaining their efficacy in reducing reliance on CRAs by investors while at the same ensuring that incentives remain strong to encourage the markets to undertake rigorous credit assessment.

d) Improving the quality and reliability of CRAs rating methodologies; assessing the opportunity of incorporating sustainability considerations into them

Insufficient transparency on how CRAs operate, how they issue ratings, what methodologies they employ and how they communicate credit ratings to market participants have been identified as important failings that have led to the poor rating quality observed in some instances during the financial crisis.

According to experts at the 2013 thematic debate, of the three segments of debt (corporate, sovereign and structured finance), the ratings on corporate debt have been relatively accurate. The major challenges, according to them, have been ratings of structured financial products, where CRAs have had difficulties in keeping pace with the growth and complexity of these products. In particular, an incorrect measurement of correlations of underlying securities in asset backed securities caused ratings errors that led to enormous mispricing in the market and contributed to the crisis.

There was less clarity on the efficacy of sovereign credit ratings, which may not have been the primary source of concern during the 2008 financial crisis but generated considerable attention during the economic turmoil in Greece and also contributed to earlier crises in emerging economies in Asia, Latin America and Eastern Europe. Given the importance of political issues and domestic policies in sovereign ratings, these ratings are often subject to greater subjectivity than corporate ratings. Sovereign ratings are of particular concern to sustainable development as inaccurate ratings can raise the cost of financing for borrowing countries. Several measures have been taken in various jurisdictions to mitigate these risks. For instance, in the EU, the CRA III Regulation in 2013 included new rules on sovereign ratings aimed at increasing the transparency and the quality of these ratings, such as the requirements for CRAs: (i) to publish a calendar for sovereign ratings and a detailed research report explaining all factors and underlying assumptions taken into account, (ii) to limit

[8] According to art. 8b of the CRAIII Regulation, the issuer, the originator and the sponsor of a structured finance instrument (SFI) established in the Union must, on the website set up by ESMA, jointly publish detailed loan data information on the SFIs;

unsolicited sovereign ratings to three per year, (iii) to review sovereign rating at least every six months to ensure they follow up more closely the economic situation of the rated entities. In addition, for all ratings, the CRAs shall inform the rated entity of the principal grounds on which the credit rating or rating outlook is based in order to give the rated entity an opportunity to draw the attention of the credit rating agency to any factual errors.

One methodological concern is a conflict between stability of ratings and forward looking ratings. CRAs have noted that in the past they used a 'through the cycle' methodology that aims to achieve rating stability i.e. their ratings reflect the ability of the borrower to repay the debt regardless of whether the economy is growing or slowing down. This minimizes the incidence of reversals and pro-cyclicality in ratings. However this sits uncomfortably with evidence that ratings have in many instances been pro-cyclical and tended to follow rather than lead the market. In addition, in the 2013 meeting, some speakers noted that following the crisis there was pressure on CRAs to be forward-looking and to better reflect the current economic environment and systemic shifts in their ratings. The ECOSOC meeting could consider how CRAs have managed to balance these conflicting demands. It could, for example, discuss the viability of introducing alternative rating approaches based on scenario or stress testing (i.e. the ratings could assess borrowers' probability of default according to a range of possible scenarios).

Following the financial crisis, efforts have been made in several jurisdictions to improve the transparency and quality of the rating process. For instance, according to EU legislation, CRAs shall use rating methodologies that are rigorous, systematic, continuous and subject to validation including by appropriate historical experience. CRAs shall also disclose information to the public on the methodologies and key rating assumptions they use. In addition, they shall consult stakeholders on material changes or new methodologies.

The meeting could discuss the steps already taken in various jurisdictions to improve transparency and clarity on methodologies and identify potential scope for further improvement. It could also consider whether it would be appropriate to encourage CRAs to incorporate sustainable development considerations in ratings across their economic, social and environmental pillars. As a result of increasing investor interest, indices and ratings have been produced by specialized sustainability rating agencies and index providers (for instance the Dow Jones Sustainability Indices and the FTSE4Good Index Series). Efforts have also been made at the international level with the Global Initiative for Sustainability Ratings launched in 2011.

According to certain views, these initiatives could gain greater traction if the major rating agencies were to incorporate economic, environmental, social and governance (EESG) criteria into their methodologies. On the other hand, mixing in a single indicator (i.e. the credit rating) two different assessments (an assessment of the creditworthiness and an assessment of the sustainability of an entity /financial instrument) could create significant confusion amongst investors.

e) <u>Promoting better global coordination, standards and reach of ratings</u>

To strengthen the credibility and usefulness of ratings, there have been calls for international efforts. One recommendation made in the thematic debate was for a global rating platform to compile information and enable investors to access ratings. In addition, there were calls to

better coordinate and harmonize ratings across jurisdictions. Taking this one step further, there were calls for supranational regulation of CRAs, with standards for ratings established at the global level. Consideration could also be given to the issue of establishing regional credit rating agencies that may be better tuned to serving the needs of regional borrowers and investors. Efforts in these areas would require collaboration between international, regional and national organizations, both public and private.

3. Outcome

The President of ECOSOC will submit a summary of the debate which will be distributed to Member States and posted on the website, emphasizing conclusions reached and proposals made. The meeting should also been seen as part of the substantive preparatory process for the third International Conference on Financing for Development, to be held in Addis Ababa in July 2015.

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