Introduction

1. The ECOSOC meeting on “The Impact of Credit Rating Agencies on Financing for Sustainable Development” discussed the role of credit rating agencies (CRAs) in influencing the flow of finance towards companies, projects and sovereigns across the world. Shortcomings in the credit rating industry, that became apparent in the recent financial crisis, were discussed with a view to assessing the impact of credit rating agencies on financing for sustainable development and to arrive at practical suggestions that can serve as an input to the preparatory process for the third International Conference on Financing for Development.

2. The meeting was chaired by H.E. Ambassador Martin Sajdik, President of the Economic and Social Council and moderated by Ms. Merli Baroudi, Director and Chief Credit Officer, World Bank Group. The panelists were 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; and Professor John Coffee, Columbia University Law School.

3. The meeting began with opening remarks by Ambassador Sajdik and an introductory statement by Ms. Baroudi. Following this, each of the panelists made a brief intervention followed by an interactive discussion that was moderated by Ms. Baroudi. Ambassador Sajdik concluded the meeting with closing remarks. The main points raised during the meeting are summarized below.

Opening remarks and initial interventions

4. H.E. Ambassador Martin Sajdik stressed that properly functioning credit rating agencies are of utmost importance as they influence the ability of both sovereigns and corporations to borrow and finance development. He pointed out that this meeting built 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 meeting attested to the considerable influence that ratings wield on the ability of both sovereigns and corporations to borrow and finance development. He also outlined deficiencies in the credit rating industry, such as the extremely concentrated market structure and the conflict of interest in the current business model, and mentioned on-going efforts at national and international levels to address these issues as well as further efforts that may be needed. During last year’s thematic debate, a number of ideas were put forward to complement and strengthen existing efforts, including measures to increase transparency and competition, alternative structures to
address conflicts of interest, suggestions for the establishment of domestic and/or public rating agencies, and initiatives for investors to better understand the role of ratings and make better use of them. He stated that this meeting will aim to further expand on some of these ideas and introduce additional issues relevant to assessing the impact of CRAs on financing for sustainable development. Ambassador Sajdik stressed that the objective was to arrive at practical suggestions that could input into the preparatory process for the third International Conference on Financing for Development that will take place in Addis Ababa, Ethiopia from 13-16 July 2015.

5. In her introductory remarks, Ms. Baroudi stressed that CRAs have the useful and important role of ensuring greater efficiency in capital markets. According to her, the financial crisis raised questions about the effectiveness of CRAs in providing accurate ratings and demonstrated the downsides of inaccurate credit ratings as well as potential spill-over effects for financial markets and the real economy. Ms. Baroudi highlighted a number of issues relating to CRAs that have attracted attention since the financial crisis. These include the hard-wiring of ratings into the regulatory framework, the excessive reliance of investors on ratings, the lack of competition in the ratings industry, low levels of transparency pertaining to ratings methodologies and outcomes, the potential conflict of interests embedded in the current business model of ratings agencies, and the often pro-cyclical nature of credit ratings that can contribute to financial market volatility. She reported that in the six years since the crisis some areas of concern have been addressed. In addition to reforms at the national level in some countries, the G20 had approved the Financial Stability Board’s Principles for Reducing Reliance on CRA Ratings and the International Organization of Securities Commissions had revised its Code of Conduct for Credit Rating Agencies. The speaker also referred to additional areas for policy consideration including the idea of the establishment of a global rating platforms based on uniform rating scales, initiatives for investors to better understand and make better use of credit ratings, proposed measures to increase transparency and competition, alternative structures to the issuer-payer model to address potential conflict of interest and the push for establishing more domestic or public CRAs. Ms. Baroudi pointed out that among other things the panel discussion would focus on avenues for further improving the quality and reliability of credit rating methodologies, opportunities to incorporate sustainability considerations in credit ratings, addressing potential conflict of interest and measures to increase competition.

6. Ms. Chee Mee Hu elucidated how recent reforms relating to CRAs have influenced the work undertaken by Moody’s Investor Service. According to Ms. Hu, the fundamental business model has remained the same. Moody’s work continues to center around the fundamental objective of assessing the likelihood that an investor will be re-paid in full and on time and, if not, what the recovery value and the timeline of repayment. Credit ratings continue to be given by Credit Rating Committees, which assign alpha-numeric ratings that reflect the creditor’s ability to re-pay in full and on time. According to the speaker, the main changes brought about by recent regulations were a greater need for transparency, documentation, substantiation and consistency. She stated that, as Moody’s is subject to different regulatory frameworks in the different jurisdictions they operate in, the company has opted to take the most stringent approach as codified in its Code of Professional Conduct. As a watchdog within the company, the credit policy group in Moody’s has been providing guidance to the
different rating teams so as to ensure consistency and has grown in size and purview since the financial crisis. The storage of information has also been centralized. In terms of rating methodologies, Ms. Hu explained that there are different methodologies for various asset types that are designed to be transparent. She also emphasized that a strong divide between business and analytical functions which has tended to overcome conflict of interest concerns relating to the issuer pays model. The reforms have also led to staff being added to meet new requirements relating to credit policy design, compliance, technology and training and documentation.

7. Mr. Thomas Missong introduced the European Association of Credit Rating Agencies (EACRA) that was founded in 2009 after the first European regulation on credit rating agencies was adopted. The membership has since grown from 5 to 17 members who represent rating agencies of varying sizes and industry focus. He outlined measures that EU has introduced to strengthen competition in the ratings industry, which has seen the number of External Credit Assessment Institutions increase. Regulation had been introduced that stipulated that issuers or a related third party that intend to appoint at least two CRAs shall consider assigning at least one credit rating agency with no more than ten percent of the total market share in terms of revenues. That same regulation introduced a mandatory rotation rule obliging issuers of structured finance products with underlying re-securitized assets who pay CRAs for their ratings to utilize a different agency every four years, including a “cooling off”-period and an exemption rule for smaller CRAs. However, according to Mr. Missong, there is a general consensus among EACRA members that the regulations are unlikely to lead to radically improved competition in the European Union as the measures do not really tackle structural barriers. For instance, the cost of compliance remains disproportionally high for new and smaller credit rating agencies and that there is a lack of an international framework and reciprocity in regulation. According to Mr. Missong, while the number of CRAs has risen, the status quo has not been challenged and recent legislation at the European level have not gone far enough to challenge the market share of the big credit rating agencies.

8. Mr. Bruno Bertocci explained that some of the proposals that are being discussed with regard to credit rating agencies stipulate the need to consider data in a more holistic way before making an investment decision. This is akin to the way that equity investors think about potential financial opportunities. Data that is considered in making investment decisions must be material in influencing the capital allocation decision, and all material data should be available when making an investment decision. According to Mr. Bertocci, the world economy is currently moving to an asset-light model, meaning that investment analysis now needs to include intellectual property and other non-traditional assets. Governance, supply chains, climate change, energy availability and other factors influence the financial vitality of businesses or industries. According to the speaker, financial data and accounting standards have evolved, culminating in the International Financial Reporting Standards (IFRS) and the International Accounting Standards (IAS), which make it possible for investors to compare financial data. A similar convergence process is starting with regard to sustainability data and data on environment, social and governance (ESG) issues. Mr. Bertocci mentioned that the Sustainability Accounting Standards Board published a material sustainability issues map with key performance indicators at the industry level, and has been in the process of developing disclosure rules underpinning this mapping. He suggested that this data could
play a role similar to accounting data, and be used in the future when making investment decisions.

9. Professor John Coffee started his presentation by stating that CRAs can play an important role in fostering sustainable development as they reduce the uncertainty and variance associated with the corporate issuer’s future returns. This in turn reduces the cost of capital and leads to an increase in economic growth. He believes that smaller investors, who are often uninformed about certain debt issuers, will continue to rely strongly on third parties to rate the credit quality of borrowers. He noted, however, that there is a perception that CRAs sometimes inflate their ratings due to the issuer-pays model. In turn, this limits the ability of ratings to reduce the cost of capital. Mr. Coffee explained that, rather than helping to improve ratings, increased competition further aggravates this problem because CRAs are likely to worry about losing market share. Given the structure of the “issuer-pays” model, CRAs might be induced to inflate ratings to protect their market share. As users of CRAs show little willingness to pay for ratings, a drastic change might not be possible. Mr. Coffee thus suggests an alternative model, i.e. a “subscriber-chooses” model. His basic proposal is the formation of a voluntary not-for-profit organization created by the major institutional fixed income (or debt) investors, with the suggested name “Council of Investors in Debt Securities” (CIDS). It could be similar to the “Council of Institutional Investors” (CII) – a highly effective organization of equity investors in the U.S. Debt purchasers would choose a ‘lead CRA’ for each debt offering by an issuer. A related suggestion was that CIDS would enter into a Code of Ethics and Best Practices with most CRAs and major debt issuers, including sovereign issuers, that would, among other things, ensure that replacing or retaining a CRA does not influence ratings. It could also ensure consultation between the CRA and debt issuer before a ratings release or downgrade. Finally, CIDS would ask CRAs to prepare two credit ratings: one to reflect creditworthiness and the other to reflect sustainability, based on the presumption that one cannot sensibly measure both. In closing, Mr. Coffee stated that the enforcement of the Code of Ethics would be voluntary and the CIDs would investigate and report on non-compliance.

Discussion among panelists

10. In the discussion that followed, panelists were asked to comment on Mr. Coffee’s proposal. Mr. Missong found the proposal to be interesting and useful. In response to Mr. Coffee’s unfavorable view on the chance of changing to an investor-pays model he clarified that some CRAs are already operating under such a model. Mr. Missong also stressed that all CRAs would have to join the CIDS in order for it to be effective and that the process and method used to determine the lead CRA would be crucial. Ms. Hu added that Moody’s has an investor-pays model, and that some investors make use of it, although it is relatively small. She also questioned the assumption that the issuer-pays model is necessarily full of conflicts, pointing out that analysts are shielded from the business aspects of CRAs and many are not aware of the fees charged by issuers.
11. In responding, Mr. Coffee stressed that until the mid-1970s, the credit rating industry was using a subscriber-pays system. However, this system became unsustainable and the industry moved to the issuer-pays system. Under the old system, however, there was no complaint about inflated ratings. According to Mr. Coffee the goal for future reform should be to minimize the inherent conflict of interest for CRAs to be able to continue to provide their important functions. Mr. Coffee also questioned whether analysts are truly blind to the business implications of their work and stressed that regulatory efforts, in particular in the U.S., were of a cosmetic nature.

12. On the issue of competition, Mr. Missong emphasized that competition encouraged innovation by rating agencies, for example on rating methodologies, which could improve the accuracy of ratings. Competition also increased the choices available to issuers and investors which, in turn, impacted the price of ratings. Mr. Missong emphasized that over-reliance on a limited number of CRAs was one of the causes of the financial crisis and strengthened competition would thus lead to a more stable market. Mr. Coffee responded by referring a study undertaken by Bo Becker that showed that increased competition from Fitch in the credit rating agency market coincided with lower quality ratings, i.e. rating levels went up, the correlation between ratings and market-implied yields fell, and the ability of ratings to predict default deteriorated.

13. Ms. Baroudi then raised the question of whether there had been progress in encouraging investors to undertake their own credit risk assessment. According to Mr. Bertocci, professional investors use credit ratings as one component in their decision to invest. During the financial crisis, some factors in rating models proved inaccurate, particularly assumption on the correlations of underlying assets. Mr. Bertocci stressed that additional CRAs are helpful but that more refined rating methods would be even more important. Ms. Hu’s view was that different investors use ratings differently and most clients view the rating provided as one additional source of information and analysis. Mr. Missong agreed that investors should not rely blindly on the rating given by CRAs; instead, they should use it as a meaningful input into their investment decision process or as a benchmark. He however pointed out that not all investors are large enough to rely solely on their own analysis. Moreover, CRAs are regulated in several countries and alternatives to CRAs are not only difficult to identify but would also be unregulated. While Mr. Coffee agreed that there should be reduced reliance on credit ratings, he underlined that smaller institutions, for example many smaller pension funds, do not have the capacity to conduct their own detailed analysis and will continue to rely on CRAs. Mr. Bertocci agreed that small investors will continue to rely on credit ratings. He added that the mere increase in the number of CRAs using similar rating models would not solve the problem.

14. Turning to rating methodologies, Ms. Baroudi asked the panel to shed light on how to balance stability with incorporating forward looking elements in a rating. Ms. Hu explained that Moody’s was always trying to take a longer term view though a business cycle, though the length of a business cycle differs widely between assets groups and companies. More recently, there has been an increased focus what she saw as shorter-term factors, such as liquidity and access to markets. She suggested that credit ratings increasingly take into account factors such as cash reserves and debt maturities. Ms. Hu added that the rating
outlooks prepared by CRAs also play a role in providing views on a sector and send a signal to investors.

15. There was also discussion on the incorporation of sustainability data into ratings. Mr. Bertocci asserted that asset owners are beginning to make use of sustainability data. He suggested that sustainability factors are predictive of future return on investment and that many equity investors are integrating sustainability aspects into their analysis. For example, the three largest US pension funds and several European pension funds have moved in this direction with the primary goal to improve their investment decision. Mr. Missong argued that while it may be useful to include sustainability data in a credit rating analysis, CRAs should not be obliged to make use of them.

Interaction with the floor

16. Key points made during the interaction with the audience included the following:

- There was discussion of the core basis of ratings and the procedural guidelines used in the ratings process. It was pointed out that credit ratings provide an independent opinion about credit worthiness and are key to assessing whether an investor will be paid in full and on time. One participant pointed out that the main rating agencies publish their methodologies on their websites, though the level of transparency on some underlying assumptions wasn’t clear. The importance of separating business from analysis, in order to ensure the independence of analysts, was also emphasized.

- The issue of whether an intergovernmental oversight body was needed to oversee the operations of CRAs was discussed. In response, it was underscored that ratings are an art and not a science – they cannot be accurate all the time – and that CRAs police themselves all the time, publishing studies to see how they have performed.

- The absence of an international framework that ensures coordination and reciprocity in regulation was pointed out. In that regard, it was asserted that bodies that are likely to be most credible in regulating CRAs would be those that cover a large market share of the agencies, such as the SEC (Securities and Exchange Commission) in the US and ESMA (European Securities and Markets Authority) in Europe. Nevertheless, a speaker stressed that there is no body as yet coordinating regulation across jurisdictions and rating agencies at the global level.

- Other points made included the need to address the subjectivity involved in ratings, the importance of having universally accepted guiding principles for rating agencies and concerns regarding the excessive influence of ratings on sovereigns’ ability to finance development.

Closing
The session was closed by H.E. Mr. Martin Sajdik, President of the Economic and Social Council, who briefly outlined some of the broad issues covered in the meeting and thanked the distinguished panelists and moderator. He stressed that a summary of the discussions of the event would be presented to the co-facilitators of the third International Conference on Financing for Development as they embark on the process of preparing a draft outcome document.