Date: 26 February 2015
ESMA/2015/SMSG/011

ADVICE TO ESMA

Securities and Markets Stakeholder Group – Advice on Discussion Paper – The Use of Credit Ratings by Financial Intermediaries Article 5(a) of the CRA Regulation

I. Executive summary

The objective of this paper is to provide advice to the Joint Committee of the ESAs on the discussion paper on The Use of Credit Ratings by Financial Intermediaries Article 5(a) of the CRA Regulation.

The SMSG very much welcomes the Joint Committee's efforts to allow for a sound discussion on the issue of the over-reliance of the use of credit ratings as part of its preparation for its forthcoming consultation paper.

The SMSG is not in a position to provide specific evidence as a user of credit ratings so we will offer a high level view of the issue as we see it. We expand on what we believe to be the keys issues in more depth below but the SMSG would like to highlight four points which we believe the Joint Committee must take into consideration when it produces it consultation paper. They are:

- Is there evidence that intermediaries do over-rely on credit ratings? The study by the AFM, cited in the discussion paper, suggests that intermediaries do not in fact mechanistically rely on credit ratings.
- Due consideration must be given to the risks associated with alternative risk indicators/assessments. Credit ratings are a well understood "tool" for intermediaries and investors.
- Where contractual references to credit ratings are to remain, these should be to ratings from "any authorised CRA" not a specific named CRA.
- The effect that a move to alternatives will have on smaller intermediaries and market participants. Not all intermediaries, especially the smaller ones, will have the resources to carry out alternative internal risk assessments. The ESAs need to ensure that any proposals will not drive smaller intermediaries out of the industry and thus reduce choice for investors.

1. Legal Background (CRA-Regulation)

One of the objectives of the last reform of the CRA-Regulation in 2013 was to reduce over-reliance on credit ratings by financial institutions and other market participants. Similar to the regulation in the US, financial institutions should avoid entering into contracts where they solely or mechanistically rely on credit ratings and should avoid using them in contracts as the only parameter to assess the creditworthiness of investments or to decide whether to invest or divest (cf. recital 9 CRA3-Regulation). To this end, a couple of provisions were introduced in the Union law. These include the following ones:

Financial institutions and other entities shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing creditworthiness of an entity or financial instrument. SCAs in charge of supervising financial institutions shall monitor the adequacy of their credit risk assessment processes, assess the use of contractual references to credit ratings and encourage them to mitigate the impact of such references, with a view to reducing sole and mechanistic reliance on credit ratings (Art. 5a CRA-Regulation).

The Commission shall review whether references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, entities (credit institutions etc.) or other financial market participants with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and implemented (Art. 5c CRA-Regulation).

2. ESAs Tasks

On 6 February 2014 the ESAs published their "Final Report on mechanistic references to credit ratings in the ESAs' guidelines and recommendations" (JC 2014 004). The Report defines the terms "sole and mechanistic reliance" as follows (cf. para. 26).

It is considered that there is sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion.

On 23 December 2014 the ESAs published a Discussion Paper on "The Use of Credit Ratings by Financial Intermediaries – Art. 5(a) of the CRA Regulation" (hereinafter: Discussion Paper). It reflects international developments in reducing reliance on ratings (FSB Principles, IOSCO and Basel Committee, US SEC and AFM Report) and summarizes responses to the ESA questionnaire on the use of credit ratings received by national supervisory authorities (SCAs). The Discussion Paper focuses on challenges encountered in reducing contractual reliance and potential alternatives to credit ratings. It seeks input by stakeholders on these topics by 27 February 2015.

3. Comments

The CRA3-Regulation intends to tackle the problem of automatic effects deriving from credit ratings. However, reliance on ratings shall only be reduced under the condition that alternatives exist. This is made clear by the wording of the above mentioned provisions of the CRA-Regulation: SCAs shall, *where appropriate*, encourage financial institutions to

mitigate the impact of contractual references to credit ratings. All references to credit ratings in Union law for regulatory purposes shall be deleted provided that *appropriate* alternatives to credit risk assessment have been identified and implemented.

3.1 References to credit ratings in Union law

References to credit ratings in Union law can be widely observed. In particular capital requirements under Basel II and Basel III/CRR acknowledge that credit risk exposure is measured by using credit ratings. Furthermore, credit ratings are still a prerequisite for an issuer to access financial markets.

3.1.1 Credit spreads

It is proposed in literature that Credit Default Swap (CDS) spreads might be a substitute for credit ratings (e.g. empirical study by *Flannery/Houston/Partnoy* 2010: "CDS spreads are a promising market-based tool for regulatory and private purposes" and "reflect information more quickly and accurately than credit ratings"; *Partnoy/Skeel* 2007).

However, this alternative is viewed quite critically by regulators and literature. Credit spreads are highly volatile and are consistently changing (*Coffee* 2011; *Hunt* 2011; *Manns* 2013 *Richter* 2008; *Schroeter* 2014). Unlike credit ratings, credit spreads are determined by many factors, such as the liquidity of financial instruments and other risk factors. Furthermore, credit spreads are not available on primary markets (*Rhee* 2013). Thus, CDS spreads are not viewed as a viable alternative to credit ratings by the dominant opinion.

3.1.2 Internal ratings

A further approach could be a risk assessment by regulated entities themselves. It is discussed intensively in the US due to the Dodd-Franc Act.[1] In a number of cases US federal agencies acknowledged internal ratings as an alternative to credit ratings.

But this approach is also viewed critically (*Hunt* 2009; *Schroeter* 2014). It appears doubtful whether financial market participants have the relevant expertise for evaluating the creditworthiness of issuers and in particular whether they are able to assess complex instruments (*Coffee* 2011; *Jones* 2010: "The assumption that investors must do an independent analysis without relying on agencies ignores the realities of the industry.").

A second argument refers to the problem of conflict of interests. Issuers and other market participants might have diverse incentives to determine if a financial instrument meets the standard in order to get favorable treatment under the regulation (even acknowledged by the SEC in the US). A further problem is that market participants tend to be over-optimistic (*Schroeter* 2014).

A different matter is whether market participants should be required to themselves also assess the creditworthiness. This might be a convincing way to reduce systemic risks: If

[1] Sec. 939A requires each federal agency to review its regulations and identify (i) any regulation that requires the use of an assessment of the creditworthiness of a security or money market instrument and (ii) any references to or requirements in such regulations regarding credit ratings. Each federal agency has to modify the regulations identified in the review by removing all references to or requirements of reliance on credit ratings and substituting alternative standards of creditworthiness.

market participants do not react to changes in ratings in a uniform way, the systemic nature of rating effects could be reduced. However this approach is also criticized. One argument is a general one: There are again doubts whether fund managers are better suited to evaluate the risk of a default than rating agencies. This might only be the case for larger, more sophisticated institutions. A further argument relates to the purpose of an additional risk assessment: Systemic risks deriving from a sole and mechanistic reliance on ratings are only tackled if at least a significant portion of market participants react in a different way than the majority. This is questioned by literature (*Schroeter* 2014: "regulatory placebo"). In addition as the research carried out by the AFM makes clear requiring all firms to carry out internal assessments would put smaller intermediaries at a distinct disadvantage and could drive them from the industry.

3.1.3 Conclusion

Since no adequate substitute for ratings appears to exist, it will be very difficult to delete references to credit ratings in Union law. This might only be possible in particular areas of the law. Of course it is valuable to evaluate how to reduce sole or mechanistic reliance on credit ratings for assessing creditworthiness, but one should not expect too much from this approach.

3.2 Contractual references to credit ratings

Contractual references to credit ratings are widely used by market participants. On the one hand, they are provided in investment guidelines/policies of institutional investors. In order to obtain as high a return as possible and as a consequence a higher remuneration, fund managers might take disproportional risks. The purpose of contractual references is therefore to limit the fund manager's investment discretion. Typically investment policies require an „investment grade" as minimum rating; other degrees of rating can hardly be observed. Once this threshold is reached, fund managers have to sell the bonds or other financial instruments of the respective issuer. The consequences of such forced sales are severe: Massive negative influence on exchange rates have been empirically proven (e.g. *Steiner/Heinke* 2001).

On the other hand, references to ratings can be found in loan contracts. The best known example of this were the rating triggers in Enron's loan contracts (2001). According to such rating triggers, the creditor may terminate the contract or may request further security. This leads to a so-called credit cliff.

3.2.1 Prohibition

A possibility would be to prohibit rating triggers in investment policies and contracts. However, the approach restricting contractual freedom would be a very strict one and an exception in financial markets law. Therefore a prohibition has to be justified by imperative reasons of public interest.

3.2.2 Disclosure

A further way to tackle the problems could be to require disclosure of rating triggers either towards the markets or towards rating agencies.

A duty to disclose rating triggers towards the markets has already been proposed by the former CESR. In fact, a prospectus published in accordance with the European prospectus regime (Prospectus Directive and Regulation) must provide information about rating triggers in important contracts. There are however no equivalent disclosure obligations on secondary markets. Furthermore it is doubtful whether market participants would be able to evaluate disclosed rating triggers.

A promising approach could be to require disclosure of rating triggers towards rating agencies, who then would be able to consider all rating triggers when evaluating the creditworthiness of an issuer (*Schroeter* 2014). Such a disclosure obligation does not yet exist in European law. But it appears to be the accepted practice of rating agencies to ask issuers about existing rating triggers in relevant contracts. The downside could be that rating triggers will be anticipated (self-fulfilling prophecy).

3.2.3 Conclusion

Disclosure obligations might be a way to reduce systemic risks deriving from contractual references to credit ratings. However, this solution does not work for rating triggers provided by investment policies/guidelines. Therefore these should make clear that ratings do not exempt managers from making their own investment decisions.

4. Summary and conclusion

Union law is still based on the assumption that credit rating agencies are best placed to assess the creditworthiness of issuers. This is mainly due to the fact that rating agencies have the necessary expertise. In addition, ratings are easy to comprehend, made available to the public free of charge and regularly updated and adjusted (*Schroeter* 2014). This explains the difficulties to develop alternatives to credit ratings and reduce over-reliance.

Internal ratings are generally not adequate substitute for ratings. Firstly, it is doubtful whether persons evaluating the creditworthiness of issuers or financial instruments have the relevant expertise. Secondly, an internal rating always gives rise to massive conflicts of interests.

Systemic risks deriving from investment policies and contractual references might be countered by different approaches. As to investment policies, regulators should make clear that managers have to make their own investment decisions; a rating is only one aspect of many others to be taken into account by the manager. As to contractual references, disclosure obligations could be strengthened.

CRA-3 8(d) imposes an obligation on manufacturers of structured products to get ratings from two CRA and further that one of the ratings should come from a CRA with less than 10% market share. With regard to all ratings, not just those for structured products, it seems sensible when ratings are used as part of an investment policy, or contract, to remove any reference to the ratings being provided by a specific credit rating agency (typically contracts refer to S&P, Fitch and Moody's) and instead specify that a rating can come from "any authorized CRA". Risk methodology varies from CRA to CRA so it seems sensible to broadening out the pool of CRAs who can provide a rating.

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