

Reducing overreliance on credit ratings: failing strategies and the need to start from scratch

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INTRODUCTION

It is widely agreed that there should be less reliance by investors and market participants on credit ratings. A more contentious issue, however, concerns how this goal is to be achieved. Reliance on ratings may escalate into overreliance when ratings are perceived by investors as the exclusive benchmark for assessing asset qualities. The risk related to this perception is twofold.

First, investors are not incentivized to pursue their own internal credit risk assessment and to undertake proper due diligence. Second, mechanistic and parallel reliance on ratings can cause herd behaviour and cliff-edge effects, that is, simultaneous sales of debt instruments when their rating is downgraded below a certain threshold. The recent financial crisis and, above all, the current sovereign debt crisis, are regarded as examples of this phenomenon. Hence, overreliance has the potential to exacerbate the financial instability of individual countries with possible spill-over effects at global level.

In 2010 the Financial Stability Board (FSB) issued a set of principles to deal with such a problem. The proposed strategy is based on two levels of action: (i) encouraging market participants to perform their own due diligence and internal risk management; and (ii) revisiting in the regulatory framework those references to ratings which may negatively influence investors due to their potentiality to be regarded as a public endorsement of creditworthiness. So far, the translation of the two-pronged approach has made very little progress at national, regional and international levels.

This short article illustrates the reasons why the proposed approach is failing to achieve its objectives. In doing so, it will discuss overreliance on credit ratings and the strategy advanced to address this problem, including its drawbacks and how it is perceived by CRAs and users of ratings. Significantly, the approach is considered as ill-

advised and as an overreaction by the users of ratings. Consequently, this article suggests that the debate on excessive reliance should re-start on new bases.

OVERRELIANCE ON CREDIT RATINGS

Sources and implications

CRAs provide forward-looking opinions on the probability that the issuer of a debt-liability security will default on the due repayment. CRAs play a key role in the financial system through the performance of information, monitoring and certification services.

The information service is said to have the advantage of reducing information costs, increasing the pool of potential borrowers and promoting liquid markets since it reduces information asymmetries between issuers and investors.

Outlook and watch procedures, on the other hand, are part of the monitoring service and work as signals to issuers of possible downgrades so that they can take all the necessary actions to avoid them.

In addition, the theoretical literature focuses on the certification role of credit ratings, that is to say, the hardwiring of ratings into financial contracts and regulations. For instance, ratings are embedded into the investment mandates of life insurers, pension funds and mutual funds. Also, access to some financial markets is restricted to issuers having ratings above a certain threshold. Furthermore, many financial contracts include rating triggers which accelerate debt repayment or terminate credit availability in the event that the debtor's creditworthiness shifts from investment to speculative grade.

The hardwiring of credit ratings into legislative provision, regulatory frameworks and financial contracts may lead to undue reliance by investors and market participants. Favourable credit ratings may be perceived by investors and market participants as a seal of approval of

creditworthiness and result in investors not performing their own risk assessments and due diligence. Relying mechanistically and exclusively on external credit ratings also has negative implications in terms of herd behaviour and cliff-edge effects. While herd behaviours represent the systematic and erroneous decision-making by a group, cliff-effects are concerned with the simultaneous sell-off of securities in case of abrupt downgrades.

When rating changes occur, a downward price spiral with negative effects on the financial stability across countries may be triggered too. The recent financial crisis and the current sovereign debt crisis in the Euro area are regarded as examples of such phenomena. In particular, it is argued that overreliance on external ratings has exacerbated financial instability in individual countries with spill-over effects at the European and global levels. Consequently, there is broad consensus at international, national and regional levels to intervene in order to limit excessive reliance on ratings and pre-empt any adverse consequences.

DEALING WITH OVERRELIANCE: STEPS TOWARDS A STRATEGY

Where do credit ratings proliferate?

In the aftermath of the 2007-09 financial crisis, the Financial Stability Forum (FSF) argued that some institutional investors had relied too heavily on ratings in their investment guidelines and choices, in some cases fully substituting ratings for independent risk assessment and due diligence. Based on this premise, the FSF mandated the Joint Forum to conduct a survey on the use of external credit ratings by its member authorities in the banking, securities and insurance sectors.

In the Stocktaking on the Use of Credit Ratings (2009), the Joint Forum detailed a widespread use of credit ratings in the legislation, regulations and supervisory policies (LRSPs) of 12 member jurisdictions. In this context, credit ratings were used for five main purposes: (i) determining capital requirements; (ii) identifying or classifying assets, usually in the context of eligible investments or permissible asset concentrations; (iii) providing a credible evaluation of the credit risk associated with assets purchased as part of a securitization offering or a covered bond offering; (iv) determining disclosure requirements; and (v) determining prospectus eligibility. Among these categories, the use of credit ratings for determining net and regulatory capital requirements was reported as predominant. Moreover, the survey noted that the North America LRSPs used references to credit ratings more than in the LRSPs of the EU, Australia and Japan. This can be traced back to the fact that the USA is the place where the credit rating industry developed and major CRAs acquired regulatory power as Nationally Recognised Statistically Rating Organisation (NRSROs) agencies.

The term NRSROs was adopted in 1975 by the Security Exchange Commission (SEC) for determining capital

charges on different grades of debt securities under the net capital rule. On revising the net capital rule for broker dealers, the SEC required to incorporate only credit ratings issued by NRSROs. In essence, the SEC's net capital rule required write-downs on the broker dealers' balance sheet for risky or speculative securities. Write-downs did not apply for securities rated triple A.

However, to avoid a "race to the bottom" in the provision of ratings, the SEC only recognised the credit ratings issued by CRAs which were granted the status of NRSROs. To this end, only the major CRAs operating before the new net capital rule had this status and were allowed to release the required ratings to broker-dealers. Since then, references to credit ratings have become widespread in federal securities laws, state legislations and financial contracts.

In contrast to the US, references to credit ratings are more limited in the EU financial aqis and industry practices. For example, with regard to the insurance and reinsurance sector the existing framework of directives does not contain any references to credit ratings. There is, however, more widespread use of credit ratings in the banking sector, and the Capital Requirement Directive (CRD) refers to the credit ratings provided by External Credit Assessment Institution (ECAI) for measuring capital requirements under the Basel II standardised approach.

The two-pronged approach

In October 2010 the FSB issued a set of principles to reduce excessive reliance on credit ratings. Strategy is based on a two-pronged approach: first, banks, market participants and institutional investors are encouraged to perform their own due diligence and internal risk management and not to rely exclusively on CRA ratings; and second, standard setters and authorities are required to assess references to CRA ratings in standards, laws and regulations and, wherever possible, remove or replace them with valid alternative standards of creditworthiness. This is the operational strategy which is to be applied to five main areas: (i) central bank operations; (ii) prudential supervision of banks; (iii) internal limits and investment policies of investment managers and institutional investors; (iv) private sector margin agreements; and (v) disclosure requirements for issuers of securities.

Specifically, central banks are encouraged to avoid mechanistic use of CRA ratings by performing their own judgment on the financial instruments they accept in market operations, both as collateral and as outright purchases. Banks must have the capability to conduct their own assessment of the creditworthiness of assets and should satisfy supervisors of that capability. Similarly, investment managers and institutional investors are required not to refer to CRA ratings as a substitute for an independent credit judgment.

In private sector margin agreements, market participants and central counterparties are cautioned against the use of changes in CRA ratings as automatic triggers for large, discrete, collateral calls in margin agreements on derivatives and securities financing transactions. What is more, the FSB document asks issuers of securities to disclose credit-relevant information in order to help investors to make an independent investment decisions.

Finally, the FSB requests standards setters and regulators to reflect on the actions to be taken to enact these principles and adapt them according to specific financial sectors and market participants.

ENACTING THE TWO-PRONGED STRATEGY: EASIER SAID THAN DONE

In its November 2011 report to the G20 Finance Ministers and Governors, the FSB summarised the current status of the progress at international, national and regional levels as to the endorsement and translation of the principles. It was claimed that the pace of translation was too slow and that so far no significant progress has been made. As I show below, this is due to inherent limits in both levels of the strategy.

Level 1: Independent credit assessment

FSB Principle II expects banks, market participants and institutional investors to make their own credit assessments and not to rely solely or mechanically on CRAs ratings. To this end, firms should ensure that they have appropriate expertise and sufficient resources to manage the credit risk they are exposed to. The principle addresses all categories of investors, from large financial institutions to less sophisticated investors.

Putting into practice this approach is hard for all these categories. Can small institutions afford to hire appropriate expertise and deploy adequate resources to perform their own credit judgment? Credit risk assessment is a complex process and constitutes CRAs' core business. CRAs have up-to-date technologies and resources adequately trained to provide an accurate credit quality analysis. Most institutions, in particular small and medium-sized enterprises, cannot afford the same resources and technologies. It is unlikely that smaller and less sophisticated investors can undertake the costs deriving from the set-up and development of an internal risk assessment model and thus they will continue to rely on the external credit quality information provided by CRAs.

Similar considerations apply to large financial institutions. FSB Principle III.2.a requires larger, more sophisticated banks within each jurisdiction to assess the credit risk of assets they hold, either outright or as collateral, irrespective of whether it is for investment or trading purposes. Banks should, where needed, enhance their capacity for internal credit assessment and

supervisors should incentivize banks to develop internal credit risk assessment capacity.

In essence, this principle fosters a model in which every financial institution performs its own rating which has to be then reviewed and approved by those who supervise CRAs. Again, it is doubtful whether even large financial institutions are available to undertake the costs related to the employment of additional resources and technology for improving internal risk management. Moreover, additional burden would be for CRA supervisors with regard to the monitoring of the implementation of different risk models.

Level 2: Removing credit rating references from legislation

FSB Principle I requires standard setters and authorities to assess references to CRAs ratings in standards, laws and regulations and, wherever possible, remove them or replace them with suitable alternative standards of creditworthiness. In the USA, section 939A of the Dodd Frank Act mirrors this principle as all Federal agencies are requested to remove any references to credit ratings in regulations and then replace any such references with an alternative standard of creditworthiness.

Success depends on two fundamental conditions: (i) global coordination among standard setters and regulators and (ii) the availability of credible alternatives to credit ratings.

Even though the FSB encourages authorities to share experiences in their efforts to reduce overreliance, so far no sign of coordination has been registered, in particular between the USA and the EU.

As to the second condition, it has to be acknowledged that there are no credit risk assessment tools accepted as credible alternatives to ratings. For instance, some proposals to replace credit ratings with market-based indicators such as credit spreads or the idea to introduce a dual rating approach based on external and internal rating did not attract any support. Standard setters and regulators are therefore facing many difficulties in providing credible alternatives to credit ratings in order to enact this level of the approach.

As we have seen, both levels have their own shortcomings. The enactment of the first level may be jeopardised by cost related problems, while the second finds its major stumbling block in the absence of valid alternatives to credit ratings.

THE STRATEGY THROUGH THE LENS OF CRAS AND USERS OF CREDIT RATINGS

On providing comments on the Office of Thrift Supervision's Advance Notice of Proposed Rulemaking regarding Alternatives to the Use of External Ratings (ANPR 2010), Moody's Investors Service (Moody's) suggested a modification of the use of the measurement

tools instead of substituting one tool for another. CRAs are essential interlocutors in the debate and their suggestions are worth being analysed jointly with the opinions expressed by the users of credit ratings.

From a CRA's perspective

Moody's invites regulatory bodies to consider carefully the extent to which risks to market safety and stability derive from the simple existence of ratings in regulation versus how ratings are being used by regulators. In this respect, it cautions against replacing the use of ratings with the use of other measurement tools, especially if these are not designed to avoid automatic triggers. In that case, excessive reliance would simply shift from credit ratings to another risk assessment mechanism.

Also, regulators are warned not to neglect the importance of ratings for financial markets. Concerns are expressed with regard to deregulating in such a way as to diminish the importance of ratings, perhaps through the elaboration of alternative measures that may trigger mechanistic responses as much as downgrades.

On one hand, Moody's seems to be not critical with regard to the proposed approach which, in the first place, might negatively impact on the business and influence of CRAs. On the other hand, there is awareness of the flaws and drawbacks inherent in the two-pronged approach.

Ratings are a fact of life and even if they were eliminated from regulatory frameworks, this would not mark the end of the power and influence CRAs have in the financial markets. Potential alternatives should be elaborated in such a way as to guarantee the same advantages that credit ratings provide to market participants and should also be constructed to avoid mechanistic reliance. However, these alternatives do not exist or are not widely accepted. This is the reason why the two-pronged approach does not (and maybe will never) succeed in reducing overreliance on credit ratings. CRAs will hardly fear a negative impact on their role and business as the highlighted limits prevent the strategy from developing coherently. Hence, the elaborated strategy results in a slow, costly and time-consuming process.

Fears from the users of ratings

What is more, the two-pronged approach is viewed with disfavour by the users of credit ratings who perceive it as a ban on using credit ratings, especially the provision concerning the elimination of credit references from legislation. As mentioned above, section 939A of the Dodd Frank Act requires US Federal agencies to remove credit rating references from their regulations and replace them with other standards of creditworthiness. To this end, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS), (collectively the

agencies), have issued their Advanced Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies (ANPR 2010), in which suggestions on potential alternatives to credit ratings are encouraged.

Until now, everyone has agreed that credit ratings cannot be eliminated. For instance, The American Securitization Forum (ASF 2010) argues that overreliance can be tackled by improving the regulation of the use of credit rating and the supervision of CRAs. ASF warns that removing credit ratings from the risk-based capital rules could have a significant impact on liquidity in the ABS markets which rely upon the ability of investors to make real-time decisions at the point of initial offering or subsequent secondary market purchase. Hence, eliminating credit ratings from these rules may jeopardise the ability of a large number of banking organisations to participate in the asset backed securities (ABS) markets, substantially reducing market liquidity.

The American Bankers Association (ABA 2012) expressed similar concerns. ABA underlines the international use and broad acceptance across the markets of credit ratings. Abandoning completely the use of credit ratings in the capital rules adopted by the US regulators could have significant negative implications for the adoption of the internationally agreed Basel III standards and lead to competitive distortions across the international banking industries. For these reasons, ABA refers to the provisions of section 939A as ill-advised and overreacting.

The Security Industry and Financial Markets Association (SIFMA 2012) emphasises the importance of credit ratings in the capital markets' determination of the creditworthiness of an issuer in measuring regulatory capital since they are transparent, easily comparable and easily available. Accordingly, potential new standards of creditworthiness must be additional or complementary to credit ratings and should not be conceived as the subterfuge to prohibit credit ratings.

RESTARTING THE DIALOGUE ON OVERRELIANCE

Broadening the concept of overreliance, improving investors' education, importance of ratings, three essential pillars

Cost-related problems, the impossibility of finding valid alternatives to credit ratings, as well as a lack of consensus among the users of ratings, are the reasons why the strategy brought forward to address overreliance remains on paper. Consequently, the debate on overreliance should re-start on new bases.

Firstly, limiting the concept of overreliance to the regulatory use of ratings is reductive. Overestimation of credit ratings can also arise because of insufficient investor education on the nature and functions of credit ratings. Credit ratings are opinions which help reduce information

asymmetries, they do not eliminate them. Thinking that credit ratings may have such a potentiality leads to misperceptions, and also generates overreliance. For example, the perfect storm of the 2007-09 financial crisis was, among other factors, caused by investors' behaviour in believing that the ratings of the tranches of structured products they were buying covered not only credit risk but also market and liquidity risks. Overreliance is a wide concept which includes the consideration of ratings as a seal of approval of credit quality from regulators as well as the misperceptions deriving from ignorance about the nature, purpose and functions of them. Therefore, it would be desirable for the debate on overreliance to consider how to effectively improve the investors' education on credit ratings.

Secondly, the message which came from the users of ratings should be of input to bear in mind that it is reasonable to contrast overreliance to the extent that it is unrealistic to believe that investors will stop relying on ratings as sources of information. Therefore, the significance of credit ratings must never be neglected in any regulatory debate involving CRAs.


CONCLUSIONS

This short article illustrates the drawbacks of the FSB's two-pronged approach as a strategy elaborated to deal with the negative implications deriving from excessive reliance on credit ratings. Such limits are the reasons why translation of the guidelines provided by the FSB is stalling at national, regional and international levels.

In general, overreliance is among the issues addressed by the regulatory debate on CRAs in the aftermath of the

financial crisis. Before the crisis, CRAs came under fire because of their role in some corporate scandals, notably in Enron's default (rated triple A until four days before the company filed for bankruptcy). The current sovereign debt crisis and the recent downgrades applied to some EU Member States have exacerbated the regulatory debate on CRAs.

Factual errors, interference in the political process as well as an anti-European bias from the major US CRAs are now the reasons why regulation is deemed to be necessary. In such a context the danger is that possible reforms on CRAs may be influenced by a trend to overreact.

In the case of overreliance, it would be interesting to discuss the extent to which the FSB's two-pronged approach, in particular the provision requiring the elimination of credit rating references from legislations and regulatory frameworks, might have been influenced by an anti-CRA bias. The negative opinions expressed by the users of ratings seem to corroborate this. Be that as it may, the inherent limits that both levels of the approach have, as well as the fear of being banned from using them raised by the users of ratings, provide compelling reasons for the adoption of new strategies to deal with what still remains a "live" issue. 

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