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Policy options to address the problem of excessive reliance on ratings

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to participate in the European Commission's "Consultation on policy options to address the problem of excessive reliance on ratings" (the "Consultation"). The CFA Institute Centre will respond separately to the Commission's related consultation on a regulatory framework for the authorisation, operation and supervision of Credit Rating Agencies (CRAs).

Preamble

The CFA Institute Centre[1] promotes fair, open, transparent global capital markets, and advocates for investors' protection. We attach great importance to the Commission's efforts to reform the CRA business in Europe, having played an active role in the CRA consultation process and policy debate. As early as March 2006, CFA Institute publicly cited the conflicts of interest inherent in the CRAs business models, and called for more accountability by rating agencies[2].

Since this period, the CFA Institute Centre has actively engaged in discussions with CRAs about their performance and has responded to a number of regulatory initiatives. These include direct communications with CRA officials, and comments to regulators in Europe and North America[3]. Through these channels, we have proposed a number of reforms to the CRA business[4], including:

- Using a rating nomenclature/categorisation that distinguishes structured products from both corporate and commercial paper ratings to help investors recognise the differences;
- Encouraging a global best practice of prohibiting the practice of "notching", whereby a CRA unilaterally issues a rating on an entity or structure that was not sought by the issuer, and for the primary purpose of "punishing" the entity or structure for not engaging that CRA;

[1] The CFA Institute Centre is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of over 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom more than 82,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.
[2] See testimony of Jeffrey J. Diermeier, CFA, CFA Institute President and CEO, to the U.S Senate in 2006 at http://www.cfainstitute.org/centre/pdf/jeff_diermeier_testimony_credit_rating_agencies.pdf
[3] See, for example, CFA Institute Centre's 2008 comment letters to IOSCO and CESR
[4] See press release at http://www.cfainstitute.org/aboutus/press/release/08releases/20080205_02.html.

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- Creating an executive-level compliance officer position at CRAs to ensure implementation and enforcement of the IOSCO code of conduct fundamentals for credit rating agencies;
- Requiring complete adoption of the IOSCO code to claim compliance;
- Calling on CRAs to refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating; and
- To refine or otherwise eliminate the concept of "investment grade" wherever possible to reduce the incidence of misconception about the purpose of the CRAs' ratings.

The need for CRA reform is further supported by the results of a recent member survey conducted by CFA Institute[5]. With nearly 2,000 responses worldwide, 47% supported the idea of a different rating system for structured products (compared to 42% who did not); and 55% indicated support for CRAs grouping themselves into an international standard-setting and monitoring self-regulatory body (compared to 30% who voted against this proposal). In other findings, when asked whether they had witnessed a CRA changing its rating in response to pressure from an investor, issuer, or underwriter, 11% of respondents answered 'yes' against 55% who answered 'no'. These results highlight the urgent need for reform of the business practices of CRAs.

Specific comments

The Consultation addresses the problem of excessive reliance on ratings. One of the primary causes behind the problems in credit markets has been the undue reliance placed on ratings by institutional investors, particularly in the banking community. Often, credit ratings have been substituted for independent due diligence in assessing the credit quality of securities. This situation has been exacerbated by the number of references to credit ratings in regulatory requirements, resulting in investors – and firms – attaching too great an importance to ratings.

The Consultation sets forth three proposals aimed at reducing the reliance placed on ratings. These comprise:

1) *Require regulated and sophisticated investors to rely more on their own risk analyses, especially for (relatively) large investments.*
2) *Require that all published ratings include 'health-warnings' informing of the specific risks associated with investments in these assets.*
3) *Examine the regulatory references to CRA ratings and revisit them as necessary.*

The CFA Institute Centre is broadly supportive of all three measures, although our preference is that legislation should be focused on proposals 1) and 2). We do not consider these proposals to be mutually exclusive; indeed, it is likely that a combination will yield the greatest benefit to investors and firms alike.

Proposals 1) and 2) address first, the behaviour of institutional investors, and second, transparency requirements associated with the publication of ratings. The two are interdependent – disclosure of 'health-warnings' regarding the specific risks of the investments being rated is crucial to enable institutional investors to effectively conduct their own due diligence. If these two proposals are successfully implemented, investors

[5] See results of survey at http://www.cfainstitute.org/memresources/monthlyquestion/2008/june.html

and firms will be more focused on performing their own risk analyses, aided through transparent rating information published by CRAs. As a consequence, "excessive" reliance on ratings is unlikely to arise.

With regards to proposal 3), whilst amending regulatory references to credit ratings is helpful, it is likely that the marginal benefit arising from this exercise will be small relative to the costs associated with revisiting regulatory references at both EU and national levels.

Ratings References

Addressing the references to ratings set out in the Consultation, we note that neither the Capital Requirements Directive (CRD) nor Solvency II Framework place undue emphasis on credit ratings. This indicates that regulatory references to ratings are not prolific in EU legislation. As the Consultation notes, *"The CRD framework as a whole provides banks with deliberate and clear incentives to use internal rather than external credit ratings even for the purposes of calculating regulatory capital requirements".* Within the CRD, however, references are made to external credit ratings in the context of securitisation exposures. With regards to Solvency II, the Consultation notes that the Framework *"…addresses credit risk but it does not contain any provisions referring to or placing reliance on credit rating agencies".*

The main regulatory references to credit ratings noted in the Consultation refer to investment funds and investment firms. In both cases, these ratings references are applied in the context of money market instruments. For investment funds, one of the key rating references follows from Commission Directive 2007/16/EC (which clarifies certain definitions used in the UCITS Directive), whereby the issuer of a money market instrument must have *'at least investment grade rating'*. For investment firms, the MiFID Implementing Directive makes a similar reference to credit ratings of money market instruments when defining the quality of security that must be held by qualifying money market funds. Specifically, a money market instrument meets the definition of "high quality" only if it has been awarded the highest possible credit rating by a CRA.

In these cases, the CFA Institute Centre would support amending the references to credit ratings, particularly in the context of the reference to 'investment grade'. As stated above, the term 'investment grade' can lead to misconceptions about the purpose of CRA ratings. We welcome the Commission's suggestion on p.5 of the document that *"… a one-size-fits-all approach need not necessarily be followed, as ratings are used in different contexts, with varying intensity and for different purposes".* Whilst our broad view (as stated above) is that the emphasis of legislation should be on policy options 1) and 2), we are encouraged by the Commission's recognition that option 3) need not be adopted in a uniform fashion to all relevant EU legislation.

Concluding remarks

In summary, we welcome the efforts of the Commission to address the problem of excessive reliance on credit ratings. The policy options put forward reflect a balanced, considered approach to reform of the CRA business. Our favoured approach is for the emphasis of future legislation to be based on policy options 1) and 2), however we recognise a (limited) role for option 3). We look forward to the outcome of the Commission's proposals.

Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

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