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7th January 2011

Dear Ms Velentza,

Re: Public Consultation on Credit Rating Agencies

Executive Summary

CFA Institute appreciates the opportunity to express its views on the proposals and considerations set out in the Commission's Public Consultation on Credit Rating Agencies.

We welcome the publication of this consultation, which focuses on the overreliance on credit ratings, the high degree of concentration in the credit rating sector and conflicts of interests associated with the issuer-pays model.

Since 2008, CFA Institute has worked with and made recommendations to both regulators and rating agencies on a global basis to improve the quality of credit ratings. In particular, we have responded to consultations and proposals from the European Commission, the Committee of European Securities Regulators, the International Organization of Securities Commissioners, the U.S. Securities and Exchange Commission, and the rating agencies on an individual basis and as a group. We also advocated to the relevant legislative committees and members in the U.S. Congress as they considered changes to financial market regulation generally, and to credit rating agency oversight specifically.

In general, our proposals and recommendations have focused on three primary changes. First, we have called for greater transparency about the ratings process and performance, to enable investors to understand the basis for ratings and any potential conflicted interests that may have arose as a consequence. We also have called for increased and improved internal controls to ensure that these firms eliminate conflicted interests where they can, and manage those that they cannot. Finally, we have called for an end to mandates from legislation or regulation that require the use of ratings generated by these ratings firms. Indeed, we believe this last suggestion as the one that will have the greatest potential effect on the accuracy and value of credit ratings in the future.

More specifically, we agree that investors and regulators, alike, have relied too much on external ratings and have far too often failed to do their own due diligence. Consequently, CFA Institute supports measures designed to increase the accountability of investors and their investment managers by reducing their overreliance on external credit ratings. References to credit ratings in regulations should be removed, or at least reduced significantly. For big, and especially systemically important firms, we agree that they should be obliged to have an internal risk management process in place which would, at the very least, verify and supplement external credit ratings. Smaller firms should be obliged to carry out due diligence, as well, though they may need to rely upon the analyses of other loan syndicate partners on particularly large credits. Over the long-term, market-based risk measures may become a valuable complement to internal credit assessments. However, we do not believe they should be used as the sole determinant of credit quality at this time.

We do not think it would be appropriate to inform the relevant country three days before publishing a sovereign debt rating. Such actions would create too many opportunities for market abuse. It is also hard to see the need for such a forewarning.

To enhance competition in the credit rating sector, statutes and regulations should not favour the existing big 3 agencies. More precisely, we support removal of requirements in regulations and capital requirements to rely upon the ratings of these incumbent firms. We do not support creation of a European Rating Agency as the best way forward due to potential implementation and conflicts of interest problems. We also do not believe that such as step would automatically improve the quality of ratings.

We do not support mandating any one specific business model for credit rating agencies. The models outlined in the consultation paper have their own problems and embedded conflicts of interests. Instead, the way forward should be a combination of the measures mentioned above. More specifically, enhanced competition in the credit rating sector should also lead to competition between different business models. This can only be achieved by removing regulatory references to the big 3 rating agencies which at the present dominate the market.

Our response to the consultation's specific questions is set out below. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,

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CFA Institute develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). CFA Institute is best known for developing and administrating the Chartered Financial Analyst® curriculum and examinations and issuing the CFA Charter.

1. *Overreliance on external credit ratings*

1.1. *Reference to external ratings in regulatory capital frameworks for credit institutions, investment firms, insurance and reinsurance undertakings*

Questions 1-6:

1. *Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?*

2. *How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?*

3. *Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?*

4. *What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?*

5. *Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed? To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?*

6. *Can the existing "supervisory formula" based approach in the Capital Requirements Directive be considered to be sufficiently risk sensitive to become the standard for all securitisation capital requirements? If not, how could its risk sensitivity be improved without placing reliance on institutions' internal estimates other than default probability and loss for the underlying exposures? In the insurance sector, how do you assess the approach to credit risk for structured exposures used in QIS 5?*

We agree that investors and regulators, alike, have relied too much on external ratings and have far too often failed to do their own due diligence. Both often ignored warning signs that the rating agencies were doing a poor job assessing structured and sovereign credits, regularly failing to downgrade troubled companies until problems were apparent to everyone. This was apparent in cases such as Enron and was repeated in the recent crisis where financial institutions' ratings were not downgraded until they were on the brink of bankruptcy.

At the same time, investors regularly were required by law and by regulation to base many investment decisions on the ratings issued by CRAs. These requirements were in place, regardless of the quality or performance of the assessments these firms made with regard to credit worthiness.

Consequently, CFA Institute supports measures designed to reduce the overreliance on external credit ratings. References to credit ratings in regulations should be removed, or at least reduced significantly. Such references have given credit ratings agencies a semi-official status which many perceived as a proof of quality and reliability. In particular, large financial firms should have to use more than one mechanism, including their own internal models, for determining capital requirements for credit risks. Smaller firms which would still rely on external ratings (i.e. use the standardized approach) should be required to use more than one rating in their models.

Market-based risk measures may become a valuable complement to internal credit assessments. However, we do not believe they should not be used as the sole determinant of credit quality at this time for several reasons. First it would require that markets, such as the credit default swaps market, be efficient. We do not believe this is entirely the case at this time. Nevertheless, we believe that over time these markets will develop into a good proxy for credit quality, particularly if develops interest from a broader spectrum of informed investors.

Secondly, to rely on market-based risk measure without mitigating factors may create a situation where capital considerations would lead some market players to sell a security which has experienced a downward trend, thereby creating a negative spiral. In a broader market downturn this would also mean that relying too heavily on market measures would be pro-cyclical. This could be avoided if such considerations were mitigated by basing capital requirements on a weighted-average value over a longer-time horizon, such as a month or a quarter, and by balancing such values with internal credit assessments based on the underlying economic reality for each issuer.

1.2. Use of external ratings for internal risk management purposes

<u>Questions 7-11:</u>

7. *Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?*

8. *What information should be disclosed to supervisors in order to enable them to monitor the internal risk management processes of firms with particular focus on the use of external credit ratings in these processes?*

9. *To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in their investment policies, risk management processes and in investment mandates?*

10. *What further measures, in addition to the disclosure proposals included in Articles 8a and 8b of the proposal amending the current CRA Regulation could be envisaged?*

> 11. *Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?*

For big, and especially systemically important firms, we agree that they should be obliged to have an internal risk management process in place which would not rely on external credit ratings. Smaller firms should also be obliged to carry out due diligence, as well, though they may need to rely upon the analyses of other loan syndicate partners on particularly large credits. For firms whose business models focus on small consumer and SME credits, for example, demanding a risk assessment for each asset would not be realistic. A better approach would call for thorough due diligence into general portfolio characteristics is crucial.

To make this format work, financial firms must be transparent about the assumptions inherent in their internal risk models. This is needed to help the supervisory authority in their assessment of the risk management process.

In general, management teams, boards of directors, and regulators all did a poor job of recognizing significant credit exposures, both within individual loan portfolios and across the broad economic spectrum. These problems were exacerbated by an overreliance on external credit ratings, but represent only part of the problem. See our comment letter regarding the Commission's Green Paper on Corporate Governance in Financial Institutions[1].

With regard to sovereign debt ratings, there is little doubt that these include an assessment of publicly available data. Indeed, sovereign credits have historically been reluctant in many cases to disclose material, non-public information, particularly in times of crisis. Nevertheless, while credit rating agencies may have significant experience in this field, this expertise can also be found elsewhere, and it may therefore be reasonable to require large financial institutions to carry out their own sovereign debt credit risk assessments, as well.

1.3. Use of external ratings in the mandates and investment policies of investment managers

> <u>*Questions 12-15:*</u>
>
> 12. *Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?*
>
> 13. *Should investment managers be obliged to introduce measures to ensure that the proportion of portfolios that is solely reliant on external credit ratings is limited? If*

[1] http://www.cfainstitute.org/Comment%20Letters/20100901.pdf

yes, what limitations could be considered appropriate? Should such limitation be phased in over time?

14. *What alternative measures of credit risk could be used to define the minimum standard of credit quality for a portfolio? Are rolling averages of bond prices/CDS spreads a suitable risk measure for this purpose?*

15. *What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates?*

Yes, to avoid disorderly markets caused by mass sell-offs, some flexibility in investment mandates is plausible. However, this proposal incorporates a presumption that mandates for investors to rely upon credit rating agency perspectives will continue. We believe this is a mistake. Firstly, such mandates replace investment analysis for determining whether and when to buy or sell a security. Secondly, such mandates create a captive market for the rating agencies which enables them to benefit regardless of the quality or accuracy of their opinions. Thirdly, rating agencies have historically waited until the 11^{th} hour to downgrade issuers, by which time astute investment managers would have already decided whether to sell the relevant securities, or to hold on with the expectation that the credits will recover over time.

With regards to whether investment managers should be required to limit the proportion of their portfolios reliant on external credit ratings, we believe this, too, is the wrong approach because it maintains the captive market for credit rating agencies. We have espoused the view that investment managers should be permitted to rely upon external ratings as much as they may wish to, but should not be required by law or regulation to do so. If they wish to rely upon external ratings, they should have to disclose to this reliance to their current and potential investors, the ratings firms upon whom they have placed their confidence, and the reasons why they have such confidence. Without a mandate, the kind of structure we describe would remove the safe-harbour currently afforded to investment managers and ultimately would make investment managers more accountable for decisions based on credit analyses.

We believe that internal credit ratings, internal credit assessments and market measures should complement each other. Overreliance on one single measure for the minimum standard of credit quality should be avoided. A combination of several measures on the other hand will create a more reliable and more robust credit assessment and at the same time reduce the likelihood of disorderly markets due to mass sell-offs.

2. *Sovereign debt ratings*

2.1. Enhance transparency and monitoring of sovereign debt ratings

<u>Questions 16-18:</u>

16. *What is your opinion regarding the ideas outlined above? How can the transparency*

and monitoring of sovereign debt ratings be improved?

17. *Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?*

18. *Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?*

We do not think it would be appropriate to inform the relevant country three days before publishing a credit rating. Such actions would create too many opportunities for market abuse. Putting safeguards in place and limiting the number of persons informed will be very difficult to achieve in practice.

It is also hard to see the need for such a forewarning. Considering that sovereign credit ratings rely on publically available data, the risk for factual errors should be limited. Furthermore, the credit rating agency can have discussions with the relevant country beforehand, just as they do with private issuers, but without communicating what the future rating may be.

While we recognize the potential benefits for investors of requiring credit rating agencies to publicly disclose their research reports on sovereign debts free of charge, we nevertheless believe this would be a bad idea. One of the reasons cited many times for the poor quality of credit ratings is that their business model does not sufficiently rely upon end-users, thus creating conflicted interests. This proposal would force the agencies to give away their product even as it considers calling on EU Member States to refrain from paying for CRA evaluations.

More frequent reviews of sovereign debt ratings are desirable. Rating agencies should, however, not be required to review sovereign debt ratings every 6 months. If the sovereign is providing accurate information to the market and the CRA, then the ratings should be inherently stable; macro economies rarely change course in a quarter or less. In addition, a general requirement would disadvantage smaller firms which may not be able to carry the cost for frequent reviews, thus causing them to refrain from issuing sovereign debt ratings.

2.2. Enhanced requirements on the methodology and the process of rating sovereign debt

Questions 19-22:

19. *What is your opinion on the need to introduce one or more the proposed measures?*

20. *More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?*

21. Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?

22. What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

We agree that credit agencies should be obliged to disclose their methodology, models and key assumptions. Holding meetings explaining their methods and assumption is another way to increase the communication between CRAs and investors. A mailbox and a Q&A on their websites to answer questions is another possibility. The requirements should however be more flexible for smaller rating agencies so as not to create to high barriers to enter the industry.

Conflicts of interests embedded in the issuer-pay model are equally present regarding sovereign debt ratings. Without another model in place, however, it might not be advisable for Member States to stop paying for the ratings. The problem arises since sovereign debt ratings, perhaps more than any other rating, can be useful to almost every investor. If everyone uses it but no one has to pay for it, the risk is that fewer resources will be devoted to it than what is desirable.

3. Enhancing competition in the credit rating agency

Questions 23-30:

23 How could new players be encouraged to enter the credit rating agency sector?

24 Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions? If yes, which asset classes (corporate, sovereign, structured finance instruments etc) could be considered?

25 Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?

26 Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level? How could such agencies be structured and funded and what entities and products should they rate? What are the potential advantages and disadvantages of this approach?

27 Is there a need to create a new independent European Credit Rating Agency? If so, *how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit rating agency? What are the potential advantages and disadvantages of this approach?*

28 Is further intervention needed to lower barriers to entry or expansion in the credit rating agency sector in general or as regards specific segments of the credit ratings business? What actions could be envisaged at EU and at Member State level?

29 Would the creation of a European Network of Small and Medium Sized Credit Rating Agencies help increase competition in the credit rating agency sector? What are the potential advantages and disadvantages of this approach?

30 Do you consider that there are any further measures that could be adopted to enhance competition in the rating business?

As in any industry, new players will enter the market if the potential for profit is high and barriers to entry are low. For the credit rating agency sector, the latter is an important factor in the high concentration of market shares with a few large agencies. This barrier to entry is mainly created by mandates that have created a captive market for these entities, including, specifically, statutory and regulatory requirements that nearly every financial institution use the ratings of CRAs to determine everything from how much capital to hold to whether an investment manager can buy, hold, or will have to sell a security. As a consequence, an "investment grade" rating by any of these firms is taken as a quality check, while a high rating from a less well known firm is seen as less valuable and even less reliable.

Changing this perception will not be easy. New players will have to earn their reputations, which is not something that regulators and policy makers can do for them. What government entities can do, however, is make sure that statutes and regulations do not give special advantage to the big firms.

The experience from the stability and growth pact clearly shows that the EU has been reluctant to issue warnings and even less to take actions toward member states which do not keep order in their public finances. While its independence may make the ECB more suited to do so, giving the central bank the authority to issue sovereign debt ratings could endanger that independence, as sovereigns may lobby it to obtain advantageous ratings, or lobby to punish it for disadvantageous ratings. Indeed, the ECB has a responsibility when it comes to financial stability, and it is therefore difficult to see that they would downgrade a member state's credit rating if it could trigger a public debt crisis.

Rating corporate bonds is not a part of a central bank's normal area of expertise and it is therefore unlikely that they are the best equipped to fulfil the task. Central banks also may have conflicted interests when it comes to corporate debts, given that they typically must watch over the financial stability of financial institutions and their regional economies. They may very well downgrade a specific company, but a broader downgrade could cause problems, especially in the case of systemically important financial firms.

As noted above, we strongly support efforts by the Commission to remove regulatory and statutory requirements for use of credit ratings by large, incumbent credit rating agencies. It is by removing the captive markets these mandates have created that it is most likely that an organic, European rating agency and rating agency business model will develop and flourish.

We see several problems associated with the creation of a new public European Credit Rating Agency, however. Firstly, such an institution would likely become another big and dominant player, thus making it even more difficult for other new and smaller entities to capture market share. Furthermore there is no reason to believe that such a public structure would issue more accurate and timely ratings than the existing competition. Its official status could nevertheless mislead market participants to assume it does provide a quality stamp. It seems to us that replacing the current overreliance on ratings issued by the big 3 with a reliance on ratings issued by a public rating agency would not necessarily lead to improved ratings quality.

4. Civil liability of credit rating agencies

Questions 31-33:

31. *Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?*

32. *If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?*

33. *Should such a potential liability regime cover solicited as well as unsolicited ratings?*

We agree that the accountability of credit rating agencies should be increased and that a greater harmonisation in this area is desirable.

5. Potential conflicts of interest in the issuer-pays model

Questions 34-36:

34. *Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?*

35. *What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the "issuer-pays" model? If so please indicate which alternatives appear to be the most feasible ones and why.*

36. *Are there any other alternatives to be considered? If so please explain.*

The issuer-pays model is tainted by conflicts of interests. With their profitability dependent on issuers, credit rating agencies have shown at least a willingness to assign higher ratings than were deserved in many cases. This has been particularly apparent in the rating of structured finance products.

CFA Institute does not, however, believe that mandating any of the suggested models is the right way forward. Eliminating the issuer/payer model would not automatically mean the elimination of all conflicts of interest in the credit ratings industry and, consequently, that there are no potential conflicts of interest with the investor-pays model. For example, big institutional investors with large exposures towards a certain security would not want to see that security suddenly being downgraded and, under the investor-pays model, the investor might attempt to pressure the credit rating agency or agencies not to downgrade. Consequently, locking in all actors with the investor-pays or any other CRA business model is not a panacea.

To address the problems with the conflicts of interest inherent in the credit ratings industry, we advocate a bottom-up or holistic approach that includes the measures suggested elsewhere in this comment letter. These include eliminating, or at least significantly reducing, the reliance on ratings through deleting all, or significantly all, statutory and regulatory references (including capital requirements) to external credit ratings. We also believe that investors and other interested parties should either engage in more internal and independent credit analyses, or be held accountable for outsourcing such matters to external rating agencies. These should be combined with more transparency from the CRAs' side, including prominent disclosure of who pays for the ratings. Finally, by making sure that the regulatory framework does not favour the existing big 3 CRAs, hopefully players with different business models can enter the market.

While we do not support either, we would find the "government as a hiring agent model" and the "payment-upon-result model" as the least objectionable alternatives proposed in the consultation. Nevertheless, we believe that the government as hiring agent model would lead to decisions that are based on factors that have little relevance to improving the quality of credit ratings. At worst, it could lead a kind of "pay-to-pay" structure, with all the potential problems such a structure can create. Likewise, we foresee the payment upon result model as another barrier to entry for smaller, new entrants to the credit rating field. The only rating agencies that could afford to wait two or three years—a reasonable period needed to determine ratings performance—for payment for their work are those that have accumulated sufficient reserves and cash from prior work to survive during the waiting period.

We do not promote the "subscriber/investor pays" model due to the "public good" nature of credit ratings. It would not be possible to keep ratings a secret; rather they will be published in the media and on the internet. If everyone gets free access to the ratings, it is hard to see that enough investors would be willing to pay for the service. Requiring institutional investors to subscribe to credit ratings would not be the best option either because such investors, like issuers, could pressure the rating agencies not to downgrade specific securities.

7 January 2011.