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Joint response to the European Commission's public consultation on credit rating agencies

The Swedish Ministry of Finance, the Riksbank and the Financial Supervisory Authority welcome efforts to reduce overreliance on credit ratings. Actors on the financial markets, including investors, must better understand the credit quality of their undertakings. We support the work on improving the framework surrounding the credit rating agencies, and we share the ambition to enhance competition and transparency, and to promote good quality of ratings. Much progress has been achieved by the regulation already in place, and a centralized supervision will add further value to this. We also recognize the principles set out by the Financial Stability Board (FSB) to reduce reliance on credit rating agency ratings which the G20 has committed to implement.

In the following, you will find our views on the ideas put forward in the current public consultation. We can largely sympathize with the objectives and many of the potential proposals put forward, but we also have some critical remarks.

1. OVERRELIANCE ON EXTERNAL CREDIT RATINGS

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?

Complex regulation may have unintended consequences and we would rather stress the importance of providing actors with the proper incentives to use more advanced models. It is preferable that the actors themselves weigh the benefits against the costs on when to use ratings and when to use internal models. In the case of SIFIs (Systemically Important Financial Institutions), however, we see the merits of a requirement to use internal models.

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

At a high level we have a positive view towards internal models. Usage of internal models requires users to better understand the drivers of credit risk as well as the risk

itself. However, it is important to recognize the role of external ratings especially for smaller investors and institutions. As pointed out by FSB, references to external ratings should be removed or replaced only once alternative provisions in laws and regulations have been identified and can safely be implemented.

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?

We are not convinced that a requirement to use at least two ratings for calculating capital requirements would generally reduce reliance on ratings. Such a requirement could however reduce the impact of individual ratings and could give more effect to the requirement that the lowest rating shall be used. Requiring firms to use at least two external ratings for calculating capital requirements could therefore be a way forward. On the other hand, since correlation between ratings generally is high and the current capital framework already requires that the lowest rating shall be used if there is more than one rating, accuracy may not improve significantly. The additional costs must be justifiable, following a thorough impact assessment.

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?

Since there is no perfect measurement of credit risk it may seem like a sound idea to gather information from many different sources including market data. However, market data e.g. in the form of CDS spreads or bond prices have several drawbacks.

First, these measurements do not only reflect credit risk. Changes in spreads may be due to changes in risk aversion, i.e. the changes in the *price of risk* instead of changes in the risk itself. Indeed, numerous studies have shown that changes in risk aversion is the main driver of changes in credit spreads, rather than changes of actual credit risk.[1] Consequently, any capital requirement based partially or wholly on this kind of market data will have a clear procyclical effect.

Second, it is difficult to ensure that the markets for e.g. bonds or CDS are sufficiently liquid to accurately reflect the markets' view on credit risk premiums. This may lead to higher as well as lower credit risk measurements than in liquid markets. Liquidity premia may cause e.g. the prices of bonds to fall below fair value but stale prices and lack of trading may lead to failed price discovery and higher non tradable prices than what fair value would suggest.

Third, in volatile markets CDS spreads and bond prices might be difficult to assess, therefore one should be cautious in using market data.

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[1] See e.g. Driessen (2005), Berndt et al (2005), Amato and Remolona (2003), Mauro et al (2002), Remolona et al (2007) and Packer and Suthiphongchai (2003).

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?

Yes, the positions must be reliably assessed for capital requirement purposes, either by using internal or external ratings. In each case, it is reasonable to require that institutions are aware of the risks related to securitisation and in particular have detailed knowledge on the risk related to securitisations in which they are investing.

We do believe that a general requirement to internally rate the exposures could have a negative impact on 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?

No, the supervisory formula based approach (SFM) is in our opinion not suitable to become standard for all securitisation capital requirements.

The Basel securitisation framework, where the SFM is only available in the absence of an external rating, builds on the view that for securitisations an external rating from one of (the three) institutions that the market utilises gives a more reliable result even for banks using internal models for other portfolios. Internal ratings based (IRB) models are developed and maintained based on historical losses for each individual banks own credit portfolio. Where a securitisation transaction comprises of assets originated by another institution then the SFM could be comparable to an external rating on the securitised assets. Compared to the rating methodology of an external rating agency the SFM can however be regarded as quite rigid due to the formula being identical for all securitisation positions while the methodology used by an external rating agency may be adapted to each specific case.

In addition the SFM is only available for banks that have IRB approval for assets similar to those underlying the securitisation transaction. This rules out application of the SFM for banks using the standardised approach for credit risk.

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?

It is desirable that internal risk management processes take more factors than credit ratings into account and not exclusively rely on external ratings. It is also important that other risks are taken into consideration, e.g. liquidity risks. Requirements to make own credit assessments for all individual exposures, however, appears too burdensome in most cases, compared to the potential benefits.

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?

In Sweden, internal models are used by the main actors and policies for risk management and investment mandates are generally approved by the executive board.

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?

It is important to provide relevant and timely information not only to unsolicited credit rating agencies, but also to other market participants in order to enable them to conduct their own independent credit analysis. Therefore, the question of which information issuers of different instruments should provide for these purposes, and how this should be done, must be dealt with.

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. 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?

Credit rating agencies use not only public information but also additional information supplied to them by the country authorities. We do not support the idea that all financial firms should carry out their own credit assessment of sovereigns. Credit assessment of sovereigns is accompanied by distinct difficulties as several unique aspects of sovereigns must be taken into account compounded by the fact that historical data of sovereign defaults is limited. This is recognized by Article 89(1) of Directive 2006/48/EC, where Internal Ratings Based banks can be exempted from using internal ratings for sovereign exposures.

Questions 12–15

We are against regulating investment guidelines and mandates of individual investment managers. These documents are best written in dialogue between investors and managers. We doubt that “flexibility clauses” or limitations of portfolios are the right way forward. Enhanced requirements on transparency regarding the use of external ratings could, however, be worth while exploring further, as well as different forms of incentivizing measures.

2. SOVEREIGN DEBT RATINGS

Questions 16-17

We believe that the market itself will demand more information and therefore see no immediate need for more regulation.

In this context, we would like to stress the vital importance of credit ratings and methodologies being monitored and reviewed on an ongoing basis, as already provided for in Article 8(5) of the CRA Regulation. Ratings must be updated much faster than today, when new facts give reason to new assessments. To this end, credit rating agencies should have adequate internal arrangements to monitor the impact of changes in macroeconomic or financial market conditions. The supervisory authority should pay close attention to this aspect.

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 see clear dangers and disadvantages of informing a country three days ahead of a publication of a sovereign debt rating. Increasing the time span between informing the issuer and informing the public, will increase the risk that the rating information may leak to unauthorized parties. This may result in illegal or inappropriate trading activities.

Increasing the time span may also increase the risk of political pressure from the sovereign on the rating agency, in cases where there are diverging views on the appropriateness of a credit rating. This may undermine the trustworthiness of sovereign ratings. Consequently, there is a distinct risk that this suggestion would undermine the independence, actual or perceived, of rating agencies. Such a development may exacerbate the conflicts of interests within the rating agency business.

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

Increased transparency concerning the rating agencies' models, methods and assumptions is a desirable development. However, these issues are covered in the recently adopted regulation. We therefore prefer that the impact of the existing legislation in this field is analyzed before any further changes are introduced.

Rating agencies are currently experiencing a crisis of confidence, mainly because of failures within the very distinct area of structured products. As a result, users of ratings, on whose trust the agencies depend for their business, are now more often demanding more information on the analytical work behind the rating. Rating agencies have a strong incentive to respond to these demands by voluntarily taking further initiatives towards greater openness and transparency. Indeed, this is already taking place. Consequently, the need for increased regulation in this field is questionable.

The need for increased transparency should not be exaggerated. Actors in the financial markets often use credit ratings as a way of outsourcing credit analysis because they may lack the time, knowledge or expertise to perform this analysis

themselves. As a result they may always not be in a position to process the extra information released by the ratings agencies.

If the existing regulation, which has not yet come into full effect, in combination with self-regulation proves to be inadequate, further steps to strengthen transparency issues may be considered. Further regulation seems premature at this point.

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?

We are against a rule that prohibits publication of either sovereign or non-sovereign debt ratings during the business day in Europe. Markets serve to incorporate information in prices. If information of any kind, including credit ratings, can only be published outside of normal trading hours then that information will be incorporated into the prices on the next trading day instead. Consequently, price movements are only shifted from one point in time to another.

Such a rule might also force trading of debt instruments and their derivatives off-shore to markets that are open during the time frame when ratings are allowed to be published. This might reduce liquidity in domestic markets and may also lead to increased, instead of decreased, volatility.

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

We do not believe that such a commitment would be the right way forward.

3. ENHANCING COMPETITION IN THE CREDIT RATING INDUSTRY

We share the ambition to enhance competition. Competition within the rating agency industry, as well as in most other industries, is generally desirable.
However, in the case of the credit rating business, substantially increased competition may not only bring benefits, but may also result in different problems. Increased competition means that an issuer will be able to choose between more rating agencies than today. This may increase the risks of rating shopping where the issuer chooses the agency that gives the most favorable rating. Furthermore, increased competition means that each rating agency will have a smaller market share than today. This means that each issuer will be a more important customer for the agency. The issuers' increased bargaining power against the rating agency, or indeed against several competing rating agencies, may result in heightened risk of inflated ratings. Consequently, increased competition may not necessarily result in more accurate ratings. We are critical of any form of government involvement when it comes to providing ratings for regulatory purposes. As stated below any government involvement in the rating process may create the illusion of government endorsed rating and serve to increase overreliance on ratings.

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?

We strongly oppose the idea to strengthen central banks', including the ECB's, role as rating agencies, see question 25 below. Credit assessment and publication of ratings are not core business for central banks. Further, any involvement by central banks in the ratings process may only serve to increase overreliance on credit ratings as they may be viewed as endorsed or even guaranteed by the central bank. The central bank's credibility, as well as the rating's credibility, might suffer if the central bank is perceived to have potential conflicts of interest. It would not be possible to counteract any undesired behavior through the ordinary supervision mechanisms.

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?

Central banks have a responsibility to properly asses the credit quality of all collateral received. Consequently, in-house development of know-how, models and other vehicles that enable an independent review of the credit quality of instruments and counterparties may serve as a powerful substitute or complement to external credit ratings.

However, publishing ratings is not something that central banks should, in our view, generally embark upon. First, it is not part of the central banks' core business to provide external credit rating services.

Second, there is a clear risk that any central bank involvement in the credit rating process may be seen as an endorsement of the rating by the central bank, thus exacerbating the very problems with overreliance that the Commission is seeking to ameliorate.

Third, the central bank may compromise its independence by acting as a credit rating agency. The consultation correctly states that central banks cannot rate sovereign debt concerning their own country. However, the consultation also states that sovereign debt ratings often constitute a cap for the rating of other issuers from the same country including public administrations, local governments, banks and private firms. Consequently, the central bank may compromise its independence by publishing ratings even though these ratings do not adhere to the sovereign per se. There may also be other conflicts of interest e.g. if the central bank were to rate systemically important banks or corporations with government connections or firms with major importance for the country's economy.

Fourth, it would not be possible to counteract any undesired behavior through the ordinary supervision mechanisms.

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?

We strongly oppose the idea of creating a new European Credit Rating Agency. Any government involvement in the rating process may create the illusion of government endorsed rating and serve to increase overreliance on ratings. Further, a European Credit Rating Agency, although formally independent, may be exposed to various political pressures e.g. through funding, appointment of executive board or other factors. Finally, we believe that it will be more difficult for a public rating agency to offer sufficiently attractive remuneration policies in order to compete with other private rating agencies for the best staff.

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?

Even if the creation of a European Network of Small and Medium Sized Credit Rating Agencies could potentially have a positive impact, is it our view that this is best organized and administrated by the market itself.

4. CIVIL LIABILITY OF CREDIT RATING AGENCIES

Questions 31-33

We do not see any need to introduce a common EU level principle of civil liability for credit rating agencies.

Differences between Member States' civil liability regimes exist not only for credit rating agencies, but also for other financial institutions. We have not seen any evidence of widespread forum shopping, either generally from financial institutions or specifically from credit rating agencies. Seperate rules for credit rating agencies would probably not fit into the legal framework of any Member State.

An extensive civil liability regime in the CRA Regulation could strengthen the overreliance on external credit ratings and reduce the incentive to make own credit assessments. In particular, we would strongly oppose a civil liability regime that covers claims for damages from third parties. The potential exposure for the business would be astronomical and affect the foundation for the business model as such. Deterrent administrative sanctions are better to prevent infringements of the CRA Regulation.

Fees for issuers and others would probably become higher, and the rating agencies might even abstain from rating certain products. It might even lead to more cautious (lower) ratings, possible leading to higher, but unwarranted, capital requirements for certain financial institutions.

5. POTENTIAL CONFLICTS OF INTEREST DUE TO THE "ISSUER-PAYS" MODEL

Conflicts of interest exist in many forms. Any model of payment, whether issuer-pays or investor-pays, is inherently exposed to different forms of conflict of interest.

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

Rating agencies, as well as most other financial gatekeepers such as auditors and investment banks, are generally paid by the issuer. Just as rating agencies compete for their business so do auditors. This may introduce a conflict of interest as the issuer can decide on which rating agency, or indeed auditor, to solicit. Generally this is solved by the fact that rating agencies, as well as auditors, depend on their reputation.

Given the oligopolistic market for ratings today each individual issuer have little bargaining power towards the CRAs as each firm only constitutes a very small share of the CRAs' business. Consequently, the potential conflicts of interest that are inherent in the issuer-pays model are in practice balanced by the relative bargain power of the issuer and the CRA.

The existing CRA Regulation contains provisions that aim to reducing the potential risk of that the issuer-pays model results in assigning higher ratings than warranted. The effect of these provisions should be assessed.

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.

It is important that the quality of ratings does not deteriorate. For credit rating agencies is it crucial to get access to information to achieve high quality of ratings. The issuer-pays model has the advantage of ensuring access to information. The existing CRA Regulation, which has not yet come into full effect, contains provisions that aim to reduce the potential risk of the issuer-pays model resulting in assigning higher ratings than warranted. As the Commission has noted other remuneration models contain other forms of interest of conflicts. In order to change remuneration model the new model should be significantly better than the "issuer-pays" model. We would also like to stress the following concerning different remunerations models.

- Government as hiring agent – even though the agent may be independent, how do we know that the rating agency has chosen has the proper competence? If credit rating agencies were to be selected randomly, they would have little incentive to compete on quality.
- Government as rater – the independence could be questioned (on similar grounds as in the case of central banks), not only as regards sovereign debt, but also when rating state-owned companies etc. A governmental body could also be suspected of considering other aspects, such as interest rates or employment etc.
- Investors as clients – may also have incentive for inflated or debased ratings due to regulatory effects or otherwise.

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

Instead of changing the remuneration model, one could consider further provisions to improve the transparency regarding the client relationship behind individual ratings.

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