ECONOMIC AND SOCIAL COUNCIL

"The Impact of Credit Rating Agencies on Financing for Sustainable Development"
(ECOSOC Chamber, 8 December 2014, 10 am to 1 pm)

PROGRAMME

Chair: H.E. Mr. Martin Sajdik (Austria), President of ECOSOC
Moderator: Ms. Merli Baroudi, Director and Chief Credit Officer, World Bank Group

Panellists:

Ms. Chee Mee Hu, Managing Director, Project Finance and Infrastructure Group, Moody's Investors Service;

Mr. Thomas Missong, President of the European Association of Credit Rating Agencies;

Mr. Bruno Bertocci, Managing Director and Global Equity Portfolio Manager, UBS Global Asset Management (Americas) Inc.

Professor John Coffee, Columbia Law School;

Interactive Discussion

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Concept Note

1. Background

By providing creditors with information on the creditworthiness of borrowers, credit ratings agencies (CRAs) play an important role in the efficient functioning of capital markets and influence the flow of finance towards countries, companies and projects across the globe. However, the financial crisis highlighted questions about the effectiveness of CRAs in providing accurate and unbiased information, and demonstrated the impact inaccurate ratings can have on the stability of the international financial system.

While credit ratings in the corporate sector have been less controversial, there have been concerns regarding the accuracy of ratings on structured finance and sovereign debt. In light of the forthcoming Third International Conference on Financing Sustainable Development, which will focus on addressing challenges in mobilizing resources for sustainable development, it is important to address these concerns. The ECOSOC meeting will build on the General Assembly Thematic Debate on "The role of Credit Rating Agencies in the International Financial System" that took place on 10 September 2013. That thematic debate provided an opportunity for Member States to exchange views and experiences with the executive heads of major credit rating agencies, senior officials of leading financial institutions and leading international and national experts.

That discussion highlighted several shortcomings in the credit rating industry that became particularly apparent after the 2008 crisis. These include the hard wiring of ratings into regulatory frameworks and excessive reliance of investors on ratings, a high level of industry concentration resulting in lack of competition, low transparency, conflicts of interests due to the issuers' pay model (i.e. issuers pay the agencies to obtain ratings), pro-cyclicality of ratings which have contributed to volatility in the real economy, and the considerable influence which sovereign debt ratings wield on the ability to borrow and to finance development.

Since the crisis steps have been taken to address many of these issues. Governments' responses have been two-fold. A number of countries have carried out reforms, such as the United States, the European Union, Argentina and China. Several initiatives have also been undertaken at the international level, including the Principles for Reducing Reliance on CRAs proposed by the Financial Stability Board and approved by the G20 and the revision of the IOSCO's Code of Conduct for Credit Rating Agencies.

stronger internal credit risk assessment practices as an alternative. They set out broad objectives which standard setters and regulators could follow and identify specific actions to implement over time.

However, at the end of 2011, the FSB observed slow progress of jurisdictions on the implementation of the principles. Consequently, in 2012 the G20 Leaders in their Los Cabos Declaration[3] and the G20 Finance Ministers and Central Bank Governors called for faster progress and the FSB therefore published a Roadmap[4] in October 2012 with timelines to accelerate the implementation of the FSB Principles. The Roadmap recognised that the removal of references to CRA ratings in standards, laws and regulations is a necessary precondition for incentivising market participants to develop their own credit risk assessment capabilities.

In order to accelerate progress on the implementation of the Roadmap, the FSB then undertook a thematic peer review[5] to assist national authorities in fulfilling their commitments under the Roadmap.

The review was structured in two stages:

- the first stage, published in August 2013, comprised a structured stock-taking of references to CRA ratings in national laws and regulations;

- the second and final stage focused on the action plans developed by national authorities to implement the Roadmap[6].

The peer review identified that the main actions to remove credit ratings from legislation have been undertaken in the US, with the adoption of Dodd-Frank Reform Act,[7] and in the EU. The overall framework in the EU to reduce reliance on credit ratings covers a wide range of regulatory measures in a multi-layer approach, covering the CRA III Regulation, sectoral legislation in financial services, actions by European Supervisory Authorities and by the relevant national sectoral authorities.
The peer review also highlighted the need for coordination of the implementation of the principles across all national agencies and bodies within a given jurisdiction, with many jurisdictions pointing to the need for guidance from international standard setters on

Reducing mechanistic reliance on rating implies to find viable alternatives. The FSB peer review highlighted that national actions plans shall envisage additional work for the development of alternative measures of creditworthiness and incentivise investors to make their own creditworthiness assessment. However, such an approach needs to be proportionate and take into account the challenges faced by smaller financial institutions with limited resources and capabilities to conduct extensive own credit risk assessments.

In the EU, specific rules have been introduced requiring financial institutions to strengthen their credit risk assessment. In addition, the EU CRAIII Regulation introduced specific transparency measures on structured finance instruments (SFIs), in order to enable investors to make their own creditworthiness assessment of these instruments[8].

Existing efforts at international and national level need to be reviewed and discussed with a view to ascertaining their efficacy in reducing reliance on CRAs by investors while at the same ensuring that incentives remain strong to encourage the markets to undertake rigorous credit assessment.

d) <u>Improving the quality and reliability of CRAs rating methodologies; assessing the opportunity of incorporating sustainability considerations into them</u>

Insufficient transparency on how CRAs operate, how they issue ratings, what methodologies they employ and how they communicate credit ratings to market participants have been identified as important failings that have led to the poor rating quality observed in some unsolicited sovereign ratings to three per year, (iii) to review sovereign rating at least every six months to ensure they follow up more closely the economic situation of the rated entities.

better coordinate and harmonize ratings across jurisdictions. Taking this one step further, there were calls for supranational regulation of CRAs, with standards for ratings established at the global level. Consideration could also be given to the issue of establishing regional credit rating agencies that may be better tuned to serving the needs of regional borrowers and investors. Efforts in these areas would require collaboration between international, regional and national organizations, both public and private.

3. Outcome

The President of ECOSOC will submit a summary of the debate which will be distributed to Member States and posted on the website, emphasizing conclusions reached and proposals made. The meeting should also been seen as part of the substantive preparatory process for the third International Conference on Financing for Development, to be held in Addis Ababa in July 2015.

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