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# Economic and Social Council Panel Explores Developing Fair, Transparent Credit Rating System that Supports Sustainable Development

## 2015 Session, 4th Meeting (AM)

ECONOMIC AND SOCIAL COUNCIL | MEETINGS COVERAGE

The collapse of the international financial system in 2008 was partly attributable to the conflicts of interest implicit in agency-client relationships and the lack of transparency in the industry, experts said today as the Economic and Social Council held a panel exploring how countries, regional organizations and United Nations agencies could work together towards a fair, transparent and more comprehensive international credit ratings system that supported sustainable development.

Martin Sajdik (Austria), President of the Economic and Social Council, opened the panel, “the impact of credit rating agencies on financing for sustainable development”, stressing that credit agencies played an important role in influencing the flow of funds for development projects. However, recent history had illustrated the system’s inherent weaknesses. The current panel discussion would seek practical suggestions that could inform the preparatory process for the Third International Conference on Financing for Development to be held in July 2015 in Addis Ababa, Ethiopia.

Moderating the panel, Merli Baroudi, Director and Chief Credit Officer, World Bank Group, said that credit rating agencies had performed a very important role in the efficiency of capital markets, but they needed improvement in a number of areas, including the hardwiring of ratings in the regulatory framework, the excessive reliance on ratings by issuers and investors, the lack of competition among agencies, low transparency, the potential conflicts of interest that ratings agencies had when seeking clients, and the observation that ratings could be pro-cyclical and contribute to market volatility.

During the morning meeting, the four panellists tackled the issue of how to include sustainability data in evaluating the credit-worthiness of a country. Bruno Bertocci, Managing Director and Global Equity Portfolio Manager of UBS Global Asset Management (Americas) Inc., said that factors such as governance supply chain and climate change were key inputs and that the data had evolved over the past 20 years, making it possible for investors to analyse it on a comparable basis.

Offering a possible solution to the conflict of interest inherent in the “issuer-payer” model, John Coffee, of Columbia University School of Law, recommended an independent body that would oversee the agency process, allowing for a lead agency to work in a conflict-free way, and including separate ratings for sustainability on one hand, and credit-worthiness on the other.

Thomas Missong, President of the European Association of Credit Rating Agencies, addressed the need to improve competition in the market, but noted that despite the efforts of small companies to enter the business, there remained many barriers, such as the cost of compliance and regulations across markets, and restrictions in many countries that limited what an entrant from an outside country could do.

Also touching on improving transparency, Chee Mee Hu, Managing Director of the Project Finance and Infrastructure Group of Moody’s explained that in adapting to the exigencies of the post-financial crisis, her company had developed self-policing mechanisms that spanned several platforms and incorporated many differing regulations. They had added staff and were performing many more compliance functions than ever before, which added to the transparency of the ratings process, and increased its global applicability.

The Economic and Social Council will meet again at a date and time to be announced.

Opening Remarks

MARTIN SAJDIK (Austria), President of the Economic and Social Council, opening the panel discussion on “The impact of credit rating agencies on financing for sustainable development”, stated that credit agencies played an important role in influencing the flow of funds for development projects. During the financial crisis, inaccurate ratings had adversely affected the international financial system. Several shortcomings in the credit rating industry had become apparent in the 2008 crisis. They included the extremely concentrated structure of that industry, the conflict of interest in the current business model, and the lack of transparency, all of which contributed to volatility in the economy. Efforts were being made to address those issues and the objective of the current panel discussion was to arrive at practical suggestions that could be fed into the preparatory process for the Third International Conference on Financing for Development to be held in July 2015 in Addis Ababa, Ethiopia.

Panel

MERLI BAROUDI, Director and Chief Credit Officer, World Bank Group, and moderator of the panel, then introduced the panel, saying that credit rating agencies had performed an important role in providing greater efficiencies in capital markets, but that the financial crisis had demonstrated the downside of inaccurate ratings.  There were many areas where the panel could examine the issues in more detail, among them the hardwiring of ratings in the regulatory framework, the excessive reliance on ratings, the lack of competition among agencies, low transparency in creating ratings, potential conflicts of interest, and the observation that ratings can be pro-cyclical and contribute to market volatility.  Many steps had been taken to address those areas of concern at the national and international levels.  The G20 (Group of 20) Summit approved and revised the code of conduct for credit rating agencies, and the debate at the United Nations had looked at the establishment of a ratings platform and other specific measures to increase transparency and competition.

The panel, she said, would look at more practical ideas, among them, avenues to increase the accuracy and reliability of ratings, and how to address conflicts of interest.  Some countries had adopted procedures to minimize the inherent conflict of interest in the issuer-payer model, such as the Dodd-Frank Act in the United Sates, and the European Union legislative framework in Europe.  The second area of concern was measures to increase competition:  Moody's, Standard and Poor's, and the Fitch group together held about 95 per cent of the market share worldwide.  For example, it wasn't as easy as it seemed to use regulatory measures in the Union to build competition.  Greater competition could also lead to a multiplicity of ratings, and with some agencies offering better ratings in an effort to be hired.

Reducing mechanistic reliance on credit ratings implied finding other solutions, and improving the reliability of those ratings was an area of particular interest, she said.  Insufficient transparency had been an important area of concern, and might have contributed to the financial crisis, particularly in reference to the structured finance market.  There was evidence that ratings were sometimes pro-cyclical.  If the major agencies were to incorporate sustainable development considerations into their ratings, it could be of interest, but could also cause confusion among investors.  On promoting the better use of ratings, there were calls to increase the coordination of ratings globally, and to better coordinate and harmonize across jurisdictions and regions.

CHEE MEE HU, Managing Director, Project Finance and Infrastructure Group, Moody's Investors Service, stated that her experience at her company ranged over public finance, corporate finance, and global project finance and infrastructure.

Turning to how regulatory reforms had affected the work of her company, she said that the fundamental business model had not changed. The product Moody's sold was the answer to the question, what was the likelihood of the investor being repaid in time. The core function around which the business revolved was the credit rating committee, which created alphanumeric shorthand descriptions about an entity's ability to repay debt. However, what the regulatory reforms had brought about was increased transparency, documentation, substantiation, and consistency.

"We are doing the same things but the paperwork that evolves around what we do — the record of our compliance — has increased multi-fold," she said. Moody's had opted to take on a self-policing role because the agency operated across many different platforms and each was different and they were not completely in agreement. Therefore, Moody's had codified an investor service code of conduct. Another key avenue for consistency was that the company had a credit policy team which functioned as an internal watchdog that provided guidance in different areas. Moody's also published a methodology for each key rating area so that the process was transparent. Further, the company had added staff in many areas, such as compliance, regulatory relations, technology and training, to meet the goals of reform. Every step of the ratings process was well-documented to ensure there were no conflicts of interest.

THOMAS MISSONG, President of the European Association of Credit Rating Agencies, said his organization had been founded in 2009 and now counted 17 members. They had introduced new policies in 2013, including that all credit-creating agencies were recognized across the entire European economic area. Focusing on a few areas of concern, he said Article 8D, was the idea of rotating ratings agencies, where the contract between an issuer and a ratings agency was limited to a certain period, and afterwards there was a cooling-off period. There was an exemption for smaller agencies because of the cost of gaining new business. There was a general consensus in the Association that that represented a small start, but it did not really address the competitive issues. The cost of compliance was very high for new and smaller ratings agencies, and there was a lack of an international framework and reciprocity in legislation across countries. For example, there was a requirement to register as a ratings agency in each country, which prevented small agencies from operating internationally. Though there were now more than 100 ratings agencies globally, there had been no real impact on market share of the big three, who had instead consolidated their market share even further.

BRUNO BERTOCCI, Managing Director and Global Equity Portfolio Manager, UBS Global Asset Management (Americas), said that according to the "mosaic theory", all material data needed to be on the table before a credit rating could be assigned. The concept of materiality was central to the decision-making process. On the inclusion of sustainability data, factors such as governance supply chain and climate change were key to determining the financial viability of a project or industry. Sustainability data was evolving in the same way as accounting data had. Over the past 20 years, accounting standards had converged making it possible for investors to compare financial data on a comparable basis. Therefore, investors, asset owners, pension funds, non-governmental organizations, and credit rating agencies could look at the same data.

JOHN COFFEE, Professor of Law, Columbia University, said that credit ratings agencies could form an important role for countries' sustainable development by reducing uncertainty and variance, and thus the cost of capital. Debt issuers would place more reliance on a credit rating, but there was also a perception that credit rating agencies would inflate the assessment because of the payer model. Increased competition could aggravate the problem, because the agencies could worry about losing market share. It was clear that the end users, debt purchasers, showed little willingness to pay for ratings. How could markets move from an "issuer-pays" model to a "subscriber pays" or chooses model, he asked.

He suggested forming a body and a code of ethics and best practices that would be entered into by the credit issuers. No threats could improve a rating, for example. A code of best practices could provide consultation before a rating was released or downgraded. There should be a right for debt purchasers to select a lead credit agency for each debt offering. If the issuer paid any fee at all for the rating, it would be to the lead agency. There would be separate ratings, such as for sustainability and credit-worthiness. Enforcement would be voluntary, but with reputations involved he predicted it would work. Initially there might be a high rate of non-compliance but he predicted that would change over time.

In a dialogue session that followed, the panellists first answered questions from the moderator regarding their views on the investor-pays proposal. Mr. MISSONG said that in such a model, the rating was not public, and it had to be acquired by paying for it, but "you get a second opinion on the same issue." Ms. HU said that Moody's did offer an investor-paid rating and it was gaining some traction with institutional investors. However, she asked, while there were inherent conflicts in the issuer-paid rating, if the analysts were blind as to the commercial implications of their ratings, why was it automatically assumed that there was a conflict of interest if the issuer pays? Mr. BERTOCCI said that investors had begun to integrate sustainability data in their calculations because they influenced outcomes. For instance, investors loathed giving capital to an ill-governed entity.  Mr. COFFEE noted that until the mid-1970s, the system of credit ratings was subscriber-paid and there were no complaints.  “The party that pays the piper calls the tune,” he stressed.  It was vital to diminish the conflict of interest problem.

In response to a question on competition, Mr. MISSONG said that it drove innovation and increased the choices available to issuers.  That resulted in increased financial stability.  The more ratings agencies used, the more stable the outcome of the assessment.  Mr. COFFEE said that the great bubble in subprime mortgages had occurred when Fitch entered the market aggressively.  Studies had shown that competitive pressure would cause agencies to inflate ratings.  The answer was not to ban competition, but to be more concerned about conflict of interest.

Regarding rating methodologies, Ms. HU said that her analysts tried to take a longer-term view while also keeping in mind more immediate-term factors such as liquidity, cash reserves, and access to markets.  Further, Moody’s also changed rating outlooks if a particular sector or asset was facing a tough business environment.  That was a signal to the market that while in the longer-term they might be fine, in the short-term it might not be business as usual.

On integrating sustainability criteria, Mr. BERTOCCI said that pension funds in the United States and in Europe were moving in that direction.  Rating agencies were beginning to consider that but the market was moving quickly.  Mr. MISSONG said that several agencies in Europe did focus on sustainability criteria, but while it was meaningful to include those aspects, “from a regulatory perspective, you cannot oblige the agencies to include them”.  Some agencies had signed the United Nations-supported Principles for Responsible Investment, but that was a choice each agency made for itself and it should not be mandated by law.

In the ensuing interactive dialogue, the representative of the European Union pointed out that the financial crisis had highlighted significant concerns about credit rating agencies’ capacity to provide unbiased ratings.  Rather, the impact that untimely and inaccurate ratings could have on the stability of the international financial system had been demonstrated.  However, although reforms, instituted in Europe following the G20 Summit and the Financial Stabilization Board orientations, had helped to correct certain practices and strengthen the existing rules, further improvements were needed in the quality of risk assessments and financial stability.

Addressing the core or basic principles in the credit rating process, as posed by Ethiopia’s representative, Ms. HU said that Moody’s did not issue sovereign ratings, only corporate ratings, and provided an independent opinion.  What was being pledged to the investor translated to understanding if the investor would be paid in full and on time; therefore, she incorporated all of the analysis and information towards satisfying the needs of the investor.

Ms. BAROUDI added that the methodology for developing ratings was always published on a company's website, citing Standard and Poor's system of, for a fee, offering information on what that rating might be.

Mr. MISSONG said that in Europe there were very strict requirements in the rating process, including the separation of sales and analysis in order to ensure that the analyst not have a conflict of interest. The rating was provided to the issuer to check for factual errors over a 12-hour period. The new rules on sovereign debt ratings required a calendar of rating actions, which made sure that investors had a weekend to read the report, thus avoiding sudden market reactions that had been witnessed in the past.

In response to the representative of the Philippines's question on where ratings agencies stood on having an extra-governmental body exercising some control over their operations, Ms. HU said rating companies were now developing their own solutions to the regulatory requirements; putting themselves in the hands of another governmental party was not something they had addressed. Moody's was aiming to hold an active dialogue with regulators. Furthermore, on its website the company had published a response to regulators' concerns.

Mr. BERTOCCI also underscored that ratings agencies were not perfect. The process was fair and transparent and generally accurate, but many of the events that had driven ratings had been unforeseen. Although a certain set of investors were reliant on the ratings, the market would give its opinion as well.

There was a policy dilemma for countries, said Mr. COFFEE, and local regulations could impact the overall process. In Europe, the European Securities and Markets Authority, a relatively new body, had the authority to regulate credit agencies. In the United States it was the Securities and Exchange Commission. However, there could be a danger of making it harder for lenders to invest.

The lack of reciprocity was a very big issue for European rating agencies, said Mr. MISSONG. Offering detailed comments, he said that there was a limited list of countries, including Argentina, Mexico and the United States, among others, that could operate in Europe since country regulations had to be similar to European regulations. As well, the agencies had to be registered again in each country, which was very costly for smaller newcomers. The Financial Stability Board and the International Organization of Securities Commissions were working on regulating agencies. However, the more differences there were between those regulating bodies, the more difficult it would be to work between countries. Whether the United Nations or another body was at the core, there needed to be a system of cross-rating of the ratings agencies.

Closing Remarks

Mr. SAJDIK, thanking the speakers and delegates for the stimulating debate, stated that the discussion had provided good insights for the preparatory process for the Third International Conference on Financing for Development to be held in 2015.  Outlining the broad issues covered, he underscored the concern about the excessive reliance on investors on ratings.  Moving to a more competitive structure was not straightforward and would intensify conflict of interest problem.  Strengthening the transparency of methodologies and ensuring their accuracy and stability was another vital task that lay ahead.