RE: HOUSE OF LORDS INQUIRY: SOVEREIGN CREDIT RATINGS: SHOOTING THE MESSENGER?

HM Treasury welcomes the House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee’s report: Sovereign Credit Ratings: Shooting the Messenger?, and the opportunity to respond.

The report made a number of valid and interesting points, and the Government agrees with the overall conclusions of the Committee that:

1. Investors should ultimately take responsibility for their own investment decisions.
2. EU governments should continue with efforts to reduce mechanistic reliance on CRA ratings in legislation.
3. Credit rating agencies should continue to improve their methodology and communicate effectively with markets.
4. The EU should not press ahead with proposals to establish a public rating agency. Yet, competition in the industry should be fostered and be kept under review by the competent European authorities.

The Government’s more detailed response to the conclusions and recommendations of the report is annexed to this letter. I look forward to the debate in the House of Lords on this subject.
I am copying this letter to William Cash MP, Chairman of the House of Commons European Scrutiny Committee; Alistair Doherty, Clerk to the Commons Committee; Jake Vaughan, Clerk to the Lords Committee; Antony Willott, Clerk to Lords Sub-Committee A; Les Saunders, Cabinet Office; Kayley McMorrow and Dominique Lam, HM Treasury.

Yours sincerely,

MARK HOBAN MP
FINANCIAL SECRETARY TO THE TREASURY
**Government Response to the House of Lords Report on Sovereign Credit Ratings**

**Summary**


The Government welcomes the Committee’s inquiry into the role played by sovereign debt ratings in the euro area crisis and its valuable contribution to an important discussion. The Committee’s report concludes that while CRAs did not precipitate or exacerbate the euro area crisis, improvements can be made on the use and regulation of CRA ratings. The report assesses various policy options currently under consideration in the latest set of international reform initiatives and provides some key recommendations.

The Government recognises the importance of CRA reform and in large part agrees with the Committee’s conclusions. The UK took an active part in establishing a new regulatory framework for CRAs in Europe to address the financial instability associated with CRAs during the financial crisis. CRAs are now supervised on a pan-European basis and must comply with minimum standards around methodologies, internal controls, and disclosures. The Government is currently working closely with the Financial Stability Board, its international partners and the European Commission to develop additional policy proposals to tackle remaining issues related to CRAs. The Government’s priorities for further reform focus on three areas:

1) Reducing the hardwiring and mechanistic reliance on credit rating agencies and increasing investor sophistication in their use of ratings;
2) Improving disclosure and transparency regarding ratings and the underlying data;
3) Improving competition through lowering barriers to entry.

This Memorandum sets out the Government’s response to the conclusions and recommendations in the House of Lords’ report, taking into the consideration the views of the Bank of England and the Financial Services Authority.
Conclusions from Chapter 2: Sovereign debt and ratings

Sovereign ratings can play a useful role that contributes to the smooth and efficient working of the worldwide sovereign debt market. We note that sovereign ratings play a significant role in determining the cost to a government of borrowing money (para 22).

We recognise that sovereign ratings involve a mix of quantitative and qualitative assessments. They are not the result of a mechanistic process, but ultimately subjective views relying heavily on the judgement of the rating agencies. Investors should not rely solely on sovereign ratings as an authoritative indicator of creditworthiness, but view them as opinions that need to balanced and confirmed by other market indicators (para 33).

In our report, The future of Economic Governance in the EU, we concluded that “accurate and comparable statistics are essential if there is to be effective economic coordination between Member States”. We recognise a similar need for accurate national statistics to ensure that the rating agencies present an accurate portrayal of a country’s creditworthiness. We therefore reiterate our recommendation, set out in that report, that the Commission should bring forward legislative proposals to improve the quality of national statistical data and to strengthen further Eurostat’s powers (para 36).

While ratings are relied upon by the regulatory framework we believe it is only appropriate that sovereigns should cooperate with credit rating agencies to ensure that their ratings are as accurate as possible (para 37).

The idea that credit ratings should be suspended for countries receiving international financial assistance is entirely inappropriate and wholly impractical given that all of the ‘big three’ agencies are headquartered in the US. Furthermore, it smacks of censorship. (para 39).

1. The Government fully agrees with the Committee’s assessment that sovereign ratings rely on qualitative as well as quantitative assessment and have a role to play in ensuring well functioning international financial markets.

2. As the Committee points out in Chapters 2 and 3, investors must make informed judgments when using Credit Rating Agency (CRA) ratings - which include a degree of subjective assessment. Therefore a key Government priority for reform is to reduce the hardwiring and mechanistic reliance on CRA ratings. We agree with the Committee’s explanation that “this ‘hard-wiring’ of ratings leads to a mechanistic reaction to rating changes which may cause cliff-edge effects, herd behaviour among investors and systemic disruption” (para 65).
3. The Government strongly supports work by the Financial Stability Board (FSB) on removing the hardwiring of CRA ratings into legislation, rules and guidance, in a way which does not jeopardise financial stability. We also welcome the Committee’s support on this initiative. Standards setters are now in the process of translating the FSB’s Principles on Reducing Overreliance on Credit Rating Agencies into concrete policy proposals. The Government has encouraged the European Commission to reflect these recommendations in its own set of proposals: Credit Rating Agency Regulation 3. As part of this work, the Basel Committee is currently revising the Basel capital framework to reduce reliance on external credit ratings, including a fundamental review of the securitisation framework. All standards setters involved will be reporting back to the FSB on their progress in mid-September in advance of the G20 Finance Ministers and Governors meeting on 14-15 October. The European Commission’s work on further CRA regulation is closely joined with the FSB’s work.

4. The Government believes that more sophisticated use of ratings by investors should also be encouraged. Directives and guidance on the regulation of collective investment, for example, the Alternative Investment Fund Managers Directive (AIFMD), currently in negotiation in Europe, will oblige investors to carry out an adequate level of their own due diligence on the assets they invest in. Standard setters in Europe (formerly the Committee of European Securities Regulators - CESR, now the European Securities and Markets Authority - ESMA) and internationally (International Organization of Securities Commissions - IOSCO) have also set out that investment managers should not place undue reliance on CRA ratings. Finally, as noted in our response to the Commission’s consultation on CRA reform\(^1\), we encourage the development of best practice for investment practices with respect to CRA ratings, such as industry guidelines provided by the Investment Management Association (IMA), the European Fund and Asset Management Association (EFAMA), and the European Securitisation Forum (ESF)\(^2\).

5. As highlighted in our response to the Committee’s report on *The Future of Economic Governance in the EU*, the Government agrees that accurate and transparent national statistics are critical to identify any potential problems and to ensure that European analysis of a Member State’s fiscal position is correct. The UK already has a long tradition of producing high quality, independent national statistics and the introduction of the Office for Budget Responsibility adds a further level of transparency and independence to the reporting of our domestic fiscal position. We have shared our expertise and experience with other Member States in this area and will continue to do so.

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1. [https://circabc.europa.eu/d/d/workspace/SpacesStore/0d1ea101-b6d0-470b-b8b3-e28e4c1c0a30/BoE-FSA-Treasury_EN.pdf](https://circabc.europa.eu/d/d/workspace/SpacesStore/0d1ea101-b6d0-470b-b8b3-e28e4c1c0a30/BoE-FSA-Treasury_EN.pdf)
6. The Government agrees that the proposal to suspend ratings for countries receiving international aid would only reduce information in the financial markets, possibly leading to further contagion. Moreover, in the absence of such ratings, it is likely that shadow ratings of these countries would emerge in any case.

Conclusions from Chapter 3: The Euro Area Crisis

We do not believe that the credit rating agencies precipitated the euro area crisis. Their rating downgrades merely reflect the seriousness of the problems that sovereigns are currently experiencing in the euro area and in most cases they have followed, rather than led, market sentiment....We do not believe, therefore, that calls to regulate further credit rating agencies can be justified on the basis of their actions during the euro area crisis (para 52).

We recognise that rating changes can have disproportionate effects on the financial markets in certain circumstances. It is not entirely clear, however, that this has happened in the euro area crisis...we do not believe that it is possible to determine the extent to which rating agencies may or may not have exacerbated the crisis (para 60).

We continue strongly to support international efforts to reduce the role that credit ratings play in regulations, investment mandates and private contracts. This ‘hard-wiring’ of ratings leads to a mechanistic reaction to rating changes which may cause cliff-edge effects, herd behaviour among investors and systemic disruption (para 65).

In our view, the valid charge against the rating agencies is not that they precipitated or exacerbated the euro area crisis, but that they conspicuously failed to identify the mounting risks in some Member States. We call on the rating agencies to draw appropriate lessons from this failure, and to seek to improve their performance in future. We hope also that the markets will subject the views of credit rating agencies to more rigorous scrutiny in light of this failure. Responsibility for investment decisions ultimately lies with investors, and they should bear in mind the principle of caveat emptor when deciding how much reliance to place on the judgement of rating agencies (para 70).

7. The Government agrees with the Committee’s assessment that CRAs cannot be held responsible for precipitating or exacerbating the euro area crisis. As highlighted in previous evidence provided, the Government believes that the failings of CRAs in the financial crisis were serious and must be addressed, but they should not colour assessment of CRA ratings in the sovereign debt crisis. As such, a key priority should be the removal of the hardwiring and mechanistic reliance on CRA ratings.

8. The current sovereign crisis in Europe has arisen as a result of fundamental imbalances both within and between individual European economies. Reforms are
still needed within Europe to tackle these fundamental imbalances. These include structural reforms to improve economic performance and competitiveness.

9. However, the build-up of these imbalances was not necessarily reflected in data before the sovereign crises hit. This is why the Government supports the Committee’s recommendation that sovereigns should cooperate with CRAs in sharing factually correct information, and that the quality of national statistics in Europe should be improved. The improved availability of such data would ensure that investors, as well as rating agencies, are able to indentify fundamental problems earlier.

10. Nonetheless, the Government agrees that CRAs should always seek to learn from their past performance and improve upon their methodologies. They should endeavour to balance the need to provide investors with a reliable and stable rating that is not susceptible to excessive volatility against rating in a rapidly moving market, economic and policy environment. The effort to reconcile these two objectives is also a contributing factor to why CRA ratings typically lag behind the market. Effective and regular communication to investors throughout this process is crucial to addressing any destabilising effects that ratings can cause in certain circumstances.

11. Improvement in CRA performance should also be enhanced by the central repository of performance statistics on CRAs being established by ESMA. Disclosure of comparable performance statistics will enable investors to better assess the judgement made by CRAs on the timings and frequency of their ratings releases.
Conclusions from Chapter 4: A European Credit Rating Agency?

We received little evidence to support suggestions that the big three rating agencies approach EU sovereign ratings with a US bias. We note, however, that different approaches to credit rating are emerging from outside western financial markets. We welcome this development (para 79).

There is a compelling argument for a thorough competition inquiry into the structure and regulation of the credit rating industry. This inquiry should consider the full range of ideas proposed to increase competition in the sector, including those outlined above (para 100).

It is clear, however, that the EU should not fund, either initially or in the long-term, a credit rating foundation. An EU-sponsored credit rating agency would lack credibility with the markets which would assume that EU governments would have undue influence over its decisions (para 101).

We recognise the expertise of the IMF and OECD, and we believe that information from these two organisations, and particularly from the IMF, should be considered influential sources of information by investors. Assigning either of these organisations a more formal role in assessing the creditworthiness of sovereigns, however, would encounter significant conflicts of interest. We do not believe, therefore, that either of them should issue sovereign debt ratings (para 107).

12. The Government is fully in agreement with the Committee’s assessment on whether CRA ratings are biased, and the proposals to create a European CRA or have the International Monetary Fund (IMF) or Organisation for Economic Co-operation and Development (OECD) issue sovereign ratings.

13. Encouraging competition is one of the three Government priorities in the reform of CRA ratings. Competition must be fostered in a way which encourages a diversity of competing opinions and does not compromise the quality of CRA ratings. The Government therefore favours the approach of lowering barriers to entry rather than intervening in the market directly.

14. The Government believes this can be achieved by:

   • Removing hardwiring of particular CRA ratings in legislation and investor mandates. This is being addressed by the FSB’s work on reducing overreliance on CRA ratings.

   • Lowering barriers to entry. Under the new European registration process, CRAs must register and prove their compliance with European standards in order for
their ratings to be used in Europe. This will aid newer CRAs proving that they meet minimum standards without a long track record and existing client base. The registration process is still in progress. Already 31 CRAs have applied for registration in Europe³.

- Improving transparency and comparability of ratings and CRA performance. In addition to the central repository on CRA performance statistics mentioned earlier, the Government supports the European proposal to create a European Ratings Index, which compiles the ratings for a certain asset class from all the CRA’s operating in Europe⁴. We believe this will serve to alert investors to the heterogeneity in the European CRA industry.

15. We would welcome any entrants to the market as additional competitors. However, they should not benefit from public funding, tacit endorsement from the Government, or exemptions from CRA regulation. Rather, they should be commercial and fully contestable players in the market. A publicly-backed CRA may lack credibility, as suggested by the Committee, or may alternatively increase overreliance on CRA ratings if its ratings were interpreted as an official ‘stamp of approval’.

16. Finally, and as suggested in the House of Lords report, competition in the CRA industry should be kept under regular review. The European Commission is the competent authority to continue to survey competition in the industry. It falls to them to decide whether there is evidence of abuse of a dominant market position upon which to base a competition inquiry. Such an inquiry should have regard to the impact of recent reforms in the space as well as upcoming changes in the CRA³ package.

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³ Updated list of registered CRAs available at European Commission website: [http://ec.europa.eu/internal_market/securities/agencies/index_en.htm](http://ec.europa.eu/internal_market/securities/agencies/index_en.htm)

Conclusions from Chapter 5: EU Regulation

We welcome the EU-level regulation of credit rating agencies given their cross-border activities and impact. While we welcome the Minister’s assurance that the new regulatory framework for CRAs will remain under review, the legislation should be given time to bed down, and its effectiveness assessed, before further changes are made (para 114).

We recommend that the Government use the Financial Stability Board to push for international agreement on the regulation of credit rating agencies. Given their role regulating credit rating agencies in the EU, the European Securities and Markets Authority should be closely involved in this work (para 121).

We do not believe that credit rating agencies should be held legally responsible for the accuracy of their ratings. As is the case at present, however, they should be held responsible for negligence or misconduct when producing those ratings. Member States are currently responsible for deciding on the nature of this liability, and we do not, at the present time, believe that a convincing case has been made for the need for a harmonised standard of civil liability across the EU (para 127).

We do not believe that the ‘issuer-pays’ model presents a significant conflict of interest in relation to the rating of sovereign debt. It is, however, a significant issue with regard to the rating of corporate debt and financial products and one that deserves further, more detailed, consideration (para 133).

We do not believe that rating agencies should have to inform sovereigns three days in advance of publishing their ratings. It increases the risk that sovereigns will place undue pressures on rating agencies to change their opinion, as well as making it more likely that the information will leak in advance of the rating agencies’ official announcement. We recommend that the status quo, that is that sovereigns get 12 hours advance notice of the publication of ratings, should remain (para 137).

17. The Government agrees that it is important that the existing European legislation on CRAs should be given time to be fully embedded before making further changes to the regulatory framework. In our tripartite response to the Commission’s consultation document, the Government stressed that a third directive should take full account of the progress that has been secured to date.\(^5\) We also fully agree with the Committee’s assessment on civil liability.

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18. The Government also shares the Committee’s view that conflicts of interests are a problem, particularly in the case of structured finance instruments, rather than for sovereign bonds. The inherent conflict of interests in the CRA business is something that should be kept under review. This has to a significant extent been addressed in CRA regulation enacted since the crisis, and is being considered in the forthcoming package of measures. We argued in our response to the Commission’s consultation that it would be most effective to find ways of managing this conflict of interests within the existing business model, as other business models would not necessarily eliminate conflicts of interests.

19. The steps already taken to address conflicts of interests include inter alia requirements of CRAs registered in Europe to:

- Set up a supervisory board – EU CRAs will be required to have a supervisory board responsible for ensuring the integrity of ratings and overseeing the business of the agency including policies to prevent or mitigate conflicts of interest and to ensure that the development of methodologies is not driven by business pressures.

- Manage conflicts of interest – CRAs will need to monitor, manage and disclose or eliminate conflicts of interest. Rating analysts will need to rotate between issuers at periodic intervals to reduce the risk of conflicts of interest influencing the ratings.

- Prohibit advisory activities - CRAs will be prohibited from providing any advice or consultation on the structuring of debt securities.

20. With regard to transparency, the Government concurs that significant steps have been taken in existing European legislation to improve disclosure by CRAs of their methodologies and rating procedures. However, there are some aspects of transparency that may not have fully been addressed by existing CRA legislation and which could be improved upon if a third CRA directive was produced this year.

21. In addition, transparency of securities should be further improved. The Bank of England and European Central Bank have put in place loan level data requirements in their collateral eligibility framework for asset backed securities. This is an example of an initiative in progress that would improve transparency, allowing investors to better assess ratings against the underlying quality of the assets themselves. The Government is strongly supportive of such initiatives while always remaining cognisant of recent legislative changes in this area.

22. The Government strongly supports the Committee’s recommendation that the FSB should be used as a forum to encourage international consistency on CRA regulation.
The Government has and will continue to emphasise the importance of coordinating CRA regulation globally in international fora. We also seek to ensure that forthcoming European initiatives on CRA regulation are consistent with the FSB’s work.

23. It is worth noting that some degree of convergence in national regimes is being achieved already. Under the endorsement regime in European CRA regulation, ratings produced outside of the EU can be used in the EU only if the jurisdiction in which they were produced has a regulatory regime that is deemed appropriate. In response, major financial centres, including in the US, Canada, Australia, Hong Kong, Singapore, and Japan are already taking steps to ensure that their regulatory regimes are consistent with that of the EU.

24. Finally, the Government agrees fully with the Committee’s assessment of the inappropriateness of proposals to impose an additional or harmonised regime of civil liability on CRAs and extending the 12 hour notification period for sovereign ratings.