CHAPTER 5

Regulatory Approaches at the National, International and Regional Levels to Address Over-reliance on Credit Ratings

Introduction

As discussed, the 2007–2009 financial crisis and the European sovereign debt crisis highlighted the systemic relevance of credit rating downgrades. In particular, cliff-edge effects and herd behaviours associated with downgrades can threaten financial stability at the global level. These, in turn, are exacerbated by over-reliance on external credit ratings by investors and market participants. As elaborated, over-reliance is a behavioural phenomenon according to which external credit ratings are referred to by investors and market participants as the exclusive benchmark for assessing creditworthiness. Within the post-crisis debate on the role of CRAs, the risk of over-reliance came under the regulatory spotlight. The FSB introduced the phenomenon and gave warning about its effects. In particular, because of over-reliance investors and market participants are not incentivised to undertake their own due diligence and credit risk assessment. In the previous chapter, the hardwiring of credit ratings into legislation and regulatory frameworks, as well as the structured finance sector have been earmarked as areas at-risk to over-reliance. Different approaches have been elaborated to reduce the risk of over-reliance according to whether the risk originates from the former or latter sector.

Chapter 5 deals with the risk of over-reliance deriving from ratings-based regulation. As the title suggests, it will analyse the regulatory strategies set out to tackle this type of over-reliance. In this context, recommendations were first elaborated at the international level. Not only did the FSB spot the phenomenon, but it also encouraged authorities to check the role they assigned to credit ratings in regulations and supervisory rules. The FSB underlined that credit rating references should not facilitate undue reliance on credit ratings and should be consistent with the aim of having investors perform an autonomous judgement of risks and proper due diligence.247 The task of the authorities is

---

hence concerned with reviewing whether investment grade rating requirements in regulations and supervisory policies could be perceived by investors and market participants as an official recognition of creditworthiness and, for this reason, act as a disincentive to perform additional due diligence and credit risk assessment.\textsuperscript{248} Significantly, the tie between the public sector and the credit rating is no longer as strong as it was before the recent financial crisis. The risk of over-reliance and the suggestions brought forward by the FSB to reduce it mark the beginning of a new relationship between regulators and credit ratings.

Accordingly, this chapter assesses how the competent authorities at the national, international and regional levels have acted on the FSB’s advice. In this respect, the analysis will focus on the approaches elaborated by US regulators, the FSB and EU institutions. These are the only three macro areas in which it is possible to take stock of the progress to reduce the risk of over-reliance from the moment the FSB warned against it.

5.1 The Evolution of the Regulatory Debate

5.1.1 US Level: Section 939A of the Dodd-Frank Act: Reliance Versus Over-reliance

In US, in line with FSB inputs, the SEC launched its consultations. Consistency with FSB advice can be seen through the examination of SEC Releases issued between 2008 and 2009. These were concerned with verifying whether in the SEC’s rules and forms the requirement to use credit ratings provided by NRSROS could place an official seal of approval on credit ratings that were detrimental to the investors’ independent due diligence and credit risk analysis.

In Release No 34-58070 of 2008 the SEC sought views from the users of credit ratings as to the opportunity to eliminate credit rating references from its rules and replace them with alternative tools for measuring credit risk.\textsuperscript{249} Some significant aspects of this approach can be discussed. First, and in accordance with the FSB guidelines, the SEC proposed a review that aimed at identifying only those credit rating references that could induce uncritical reliance on

\begin{itemize}
\item \textsuperscript{248} Ibid, 38: The FSB underlined the embedment of credit ratings into legislations and regulatory frameworks at the international and national levels and remarked how such official recognition in regulations or supervisory policies may have played a role in encouraging investors’ over-reliance on ratings.
\item \textsuperscript{249} SEC, ‘References to Ratings of Nationally Recognized Statistical Rating Organization’ (2008) Release No 34-58070, File No s7-17-08.
\end{itemize}