Reducing regulatory reliance on credit ratings to address investors’ over-reliance: some thoughts in light of the US experience

Francesco De Pascalis*

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Key points

- This article discusses the legislative reforms operated by US federal agencies to implement Section 939A of the Dodd-Frank Act. This rule requires the deletion of credit rating references in legislation and their substitution with alternative standards of creditworthiness.

- Factors such as the difficulties in finding a valid, universally accepted, alternative to credit ratings and the strong criticism against the spirit and letter of Section 939A were crucial to the legislative solutions adopted by US agencies.

- On the whole, the work of the agencies can provide valuable information to those authorities, in particular at the EU level, which have drawn up plans to reduce credit rating references in legislation and regulatory frameworks.
1. Credit rating references in legislation and investors’ over-reliance

Background information

At the outbreak of the 2007-2009 financial crisis, massive downgrades applied to highly rated structured products by the major credit rating agencies (CRAs) prompted regulators and policymakers to reflect, among other issues, on the investors’ dependence on external credit ratings.¹ It was claimed that investment grade ratings assigned to debt instruments may have the effect of discouraging investors from undertaking their own due diligence and credit risk assessment.² Within the post-crisis regulatory debate, this problem was named as over-reliance on external credit ratings by investors and market participants.

The Financial Stability Board (FSB) identified the source of over-reliance in the hardwiring of credit ratings in numerous regulatory and legislative frameworks at the international and national levels. Specifically, legislative requirements to invest in highly rated securities may be interpreted by investors and market participants as ‘a seal of approval’ of

² F De Pascalis, ‘Investors’ and Market Participants’ Over-reliance on External Credit Ratings: To What Extent Does EU Law Carry This Risk?’ (forthcoming 2016) EBLR.
credit quality imprinted by regulators. Accordingly, investors and market participants would rely on credit ratings as the exclusive benchmark to assess credit risk and would not perform their own due diligence and credit risk assessment in addition to the credit quality analysis provided by CRAs.

Over-reliance is therefore a misperception of the role of credit ratings in legislation and regulatory frameworks. This would result in the investors’ and market participants’ laxness in conducting their own due diligence and credit risk assessment.

**Normative approaches in focus**

The FSB underlined that credit rating references should not facilitate undue reliance and should be consistent with the aim of having investors perform an autonomous judgement of risks and proper due diligence. Accordingly, the global approach to address the problem of over-reliance was based, first, on the reduction of credit rating references in legislation and, secondly, on the parallel enhancement of investors’ and market participants’ capabilities to conduct their own due diligence and credit risk assessment. This was finally incorporated in the set of principles for reducing reliance on credit ratings, which the FSB issued in 2010 (FSB Principles). Indeed, according to FSB Principle I, standard setters, regulators and policymakers are required to review references to credit ratings in their standards and regulations and, wherever possible, replace them with alternative standards of creditworthiness. On the other hand, FSB Principle II requires investors and market participants to undertake their own credit risk analysis and not to rely solely or mechanistically on credit ratings. The intertwine between the two levels of the FSB approach can be seen in the fact that the second level can be implemented consequently to

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4 De Pascalis (n 2).
5 FSB (n 3).
6 FSB, ‘Principles for Reducing Reliance on Credit Ratings’ (2010).
7 FSB Principle I.
8 FSB Principle II.
the development of the first level: once credit rating references are removed and replaced by alternative standards of creditworthiness, investors and market participants will be more independent from credit ratings and will prioritise their own due diligence and credit quality analysis. This strategy was endorsed during the Group of Twenty Seoul summit of 2010 and became the paradigm upon which specific legislation should be built at the national level to reduce the risk of over-reliance.9

At the EU level, the transposition of the FSB two-pronged approach can be noticed in Articles 5(a), 5(b) and 5(c) of Regulation 462/2013 (CRA regulation III).10 Both Articles 5(b) and 5(c) implement FSB Principle I. Article 5(b) requires the European Supervisory Authorities (ESAs) not to refer to credit ratings in their guidelines, recommendations and draft technical standards where these references carry the potential to trigger sole or mechanistic reliance on credit ratings by authorities and market participants. Furthermore, the rule requests the concerned authorities to review and remove, where appropriate, all such references to credit ratings in their existing guidelines, recommendations, and draft technical standards.11 Article 5(c) tasks the European Commission (Commission) with monitoring whether credit rating references in Union law can trigger undue reliance on credit ratings. As the Article specifies further, the purpose is to delete such references by 2020 once appropriate alternatives are found.12 On the other hand, the transposition of the second level of the approach into EU legislation can be identified in Article 5(a). This rule is entitled ‘Over-reliance on credit ratings by financial institutions’ and requires financial institutions to make their own credit risk assessment and not solely and mechanistically rely on credit ratings.13

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11 See Art 5(b) of CRA Regulation III.
12 See Art 5(c) of CRA Regulation III.
13 See Art 5(a) of CRA Regulation III.
However, even before the issue of the FSB Principles, in the US Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) dealt with the source of over-reliance, that is, rating-based regulation.\textsuperscript{14} Pursuant to Section 939A, all the US Federal agencies are required to review references to credit ratings in their legislation and then remove these references to substitute them with alternative standards of creditworthiness.\textsuperscript{15}

**US versus EU: similarities and differences**

Significantly, the investors’ over-reliance is tackled by reducing (or eliminating) credit rating references in legislation and enhancing the investors’ independence in conducting their own credit quality assessment and due diligence. Chronologically, the US was the first to bring forward this approach through Section 939A of the Dodd-Frank Act, while the EU rules under CRA Regulation III are the most recent. Even though the US and EU rules pursue the same objective, there are significant differences between them. These can be identified by analysing the EU approach in combination with the FSB Principles. FSB Principle I states that standard setters and regulators should, ‘wherever possible’, remove credit rating references and replace them with alternative standards of creditworthiness. Article 5(b) of CRA Regulation III specifies that the aim of the review that the European financial authorities have to conduct on their own guidelines, recommendations or draft technical standards is the identification of those credit rating references which have the potential to trigger sole or mechanistic reliance on external credit ratings by investors and market participants. Similarly, under Article 5(c) the Commission has to identify the same credit rating references by 2020. Altogether, these rules have a clear meaning: the elimination of the credit rating references, consequent to a review, is


\textsuperscript{15} Section 939(a) of the Dodd Frank Act: Review of Reliance on Ratings <https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.
subject to a condition that is, only the references which can pose a risk of over-reliance must be eliminated. Indeed, Article 5(b) uses the words, ‘where appropriate’ which has the same meaning as, ‘wherever possible’ used under FSB Principle I. Both expressions indicate that the elimination is a possibility and not a mandatory process, once the review of the credit rating references has been completed.16 Consequently, not only do specific credit rating references have to be identified and selected, but also their elimination is subordinated to the development of appropriate alternatives to the credit ratings. There are therefore two conditions upon which the EU approach is based: 1) the review aims at selecting specific credit rating references; and 2) elimination is subordinated to the elaboration of valid alternatives. This second condition has been transposed into Article 5(c) as well, under which credit rating references in Union law are to be eliminated: ‘provided that appropriate alternatives to credit risk assessment have been identified and implemented’. This is aligned with paragraph 1 of FSB Principle I, which further specifies that credit rating references should be removed or replaced only once possible alternative provisions in laws and regulations have been developed and can be implemented.17 Hence, standards setters and authorities are encouraged to develop alternative standards of creditworthiness.

As opposed to the EU rules, the US approach does not aim to select specific credit rating references. Section 939A is undoubtedly clear on this aspect. Regulators are required to identify which piece of their own legislation contains references to credit ratings. After completing the review, they will have to remove the identified credit rating references and substitute them with alternative standards of creditworthiness. Significantly, this approach pursues the total

16 See also Recital 6 CRA Regulation III: ‘the Union s working towards reviewing, at a first stage, whether any references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on such credit ratings and, at a second stage, all references to credit ratings for regulatory purposes with a view to deleting them by 2020, provided that appropriate alternatives to credit risk assessment are identified and implemented’.
17 See FSB Principle I para 1: ‘references to CRA ratings should be removed or replaced only once alternative provisions in laws and regulations have been identified and can safely be implemented’.
elimination of the credit ratings from regulations and legislative frameworks. The elimination of the credit rating references is not subordinated to the elaboration of alternatives to credit ratings. The elimination is not a possibility, but the main purpose of the review, so as to replace the credit ratings with new standards of creditworthiness.

Undoubtedly, the US approach sounds harsher than the EU approach. In a nutshell, while the US approach is based on review, removal, and replacement of credit ratings with new standards of creditworthiness, the EU approach can be summarised as follows: review, possible alternatives and, thus, possible credit rating deletion. The dichotomy between elimination and possible elimination of the credit rating references is the major difference between the US and the EU approaches. Consequently, if the general principle is that over-reliance has to be reduced by eliminating credit rating references and by enhancing market participants’ credit risk analysis capacities, this will be achieved by the US and the EU through different strategies. In the US, the market participants’ independent credit risk analysis will be encouraged once all the credit rating references are eliminated and replaced by alternative standards of creditworthiness. In the EU, the same aim will be pursued after the selection, elimination, and replacement of those credit rating references which may induce mechanistic and parallel reliance.

Based on this analysis, it can be said that only the EU rules represent a full endorsement and transposition of the FSB two-pronged approach. Despite these differences, what the US

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19 FSB, ‘Thematic Review on FSB Principles for Reducing Reliance on Credit Rating Agency Ratings: Interim Report’ (2013): ‘the United States (US) has moved the furthest in removing references to CRA ratings from law or regulation. This initiative has been the consequence of section 939A of the Dodd-Frank Act, which requires federal regulatory agencies to remove from their regulations any references to, or requirements of reliance on, credit ratings in assessments of creditworthiness and to substitute in those regulations other standards of creditworthiness that the agencies determine to be appropriate. Indeed, this legislation goes further and sets a more absolute standard than the Principles, as it requires the complete removal and replacement of CRA ratings as may be determined appropriate’.
and the EU rules have in common is the search of valid alternatives to the credit ratings. Undeniably, the overall progress of the strategy is conditioned by this aspect. Therefore, the search and set up of appropriate alternatives to the credit ratings is vital for the subsequent removal stage to be applied under both Section 939A and CRA Regulation III. Where there are significant difficulties in finding valid alternatives to the credit ratings, this may mean that the strategy is slowing down in its progress or that, to say the worst, it is doomed to fail. Moreover, possible amendments imply identifying which type of alternatives have been incorporated into the changed rules, how they work and whether the credit ratings can still play a role in the legislation. Importantly, the search for alternatives must be regarded as the milestone for stopping regulatory reliance on credit ratings and, thus, reducing the potential of over-reliance by investors and market participants.

2. The status of the US reforms under section 939A of the Dodd Frank Act

The early debate on Section 939A

Currently, the US is the country which has made more progress than any other country in the search for alternatives to credit ratings. The status of the implementation of Section 939A of the Dodd-Frank Act can be verified by analysing the amendments applied to their own legislation by the following agencies: the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA), the Federal Housing Finance Agency (FHFA), the Department of Labour (DOL), the Federal Reserve Board (FRB) and the Securities and Exchange Commission (SEC). Before taking stock of the agencies’ review work and evaluate its results some considerations are in order. Section 939A was initially conceived as a rule which should have paved the way to a new, universally accepted standard of creditworthiness in substitution for the external credit ratings. This can be confirmed by analysing the regulatory debate which followed the issuance of Section 939A. In that context, five key characteristics of a good creditworthiness standard,
as an alternative to external credit ratings, were discussed. Firstly, it was emphasised that the standard should have been reliably risk sensitive. This means that it should have effectively measured the credit risk of different types of debt instruments. Accordingly, it should have been applied in a consistent and transparent way across different types of financial instruments. Furthermore, such a standard should have been capable of auto adjusting on a timely basis in accordance with changes in the credit risk profile of instruments and auto adapting to cover new financial market practices. Finally, the standard should have been easy to understand and simple to implement, so as to avoid an excessive regulatory burden on financial institutions, in particular, small banks and firms. Importantly, the debate underlined that external credit ratings have these characteristics. Clearly, regulators were searching for something having the same qualities of the credit ratings, but not the same shortcomings. However, more than one reservation was expressed as to the possibility of implementing Section 939A in this way.

Furthermore, another crucial aspect must be taken into consideration. In the event that a new standard of creditworthiness which has the abovementioned requirements is proposed, this could only be regarded as the first step. The success of any hypothetical standard as an alternative to credit ratings also depends on the acceptance by those investors and market participants who have always relied on credit ratings. In the aftermath of the entry into force of Section 939A, it was stressed that the formulation of the rule sounded like a prohibition to refer to external credit ratings not only in legislation, but also for the users of credit ratings. In other words, the letter and spirit of Section 939A faced strong criticism. The majority of

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20 House Committee on Financial Services, ‘Oversight of the Credit Rating Agencies Post-Dodd-Frank’ (27 July 2011) Hearing Before the Subcommittee on Oversight and Investigations of the Committee on Financial Services US House of Representative One Hundred Twelfth Congress First Session, 12.
21 Ibid.
22 Ibid.
23 ‘if a valid alternative to credit ratings exists I would be very impressed since I do not have clear idea of what it is , see M Plowright, ‘Credit Rating Agencies: Under the Influence’ (2011) <http://www.emergingmarkets.org/Article/2905663/CREDIT-RATING-AGENCIES-Under-the-influence.html>.
commentators regarded this rule as ill-advised and asked for its repeal or amendment. However, these concerns and reservations were raised back in 2010, immediately after the issuance of Section 939A. Now, at the time of writing, more than five years have passed. This is a sufficient time to assess what the agencies have achieved and to discuss possible implications in relation to the global strategy to eliminate over-reliance through the reduction of regulatory reliance on credit ratings.

The US Federal agencies’ reform process

CFTC

By making a comparison between the amendments that the US agencies have applied since the issue of Section 939A of the Dodd Frank Act, an interesting evolution in the elaboration of alternatives to external credit ratings can be analysed. Specifically, it will be showed how the solutions brought forward by one agency have influenced the work of the other agencies in terms of development of their own standards of creditworthiness. To have a grasp of this evolution, it is necessary to give a chronological order to the work of US agencies. To this end, the review that the CFTC undertook, pursuant to Section 939A, is the first to be analysed.

CFTC regulations apply to future commission merchants (FCMs), derivatives clearing organizations (DCOs) and commodity pool operators (CPOs). For the purpose of Section

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24 Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing and Urban Affairs, United States Senate (Sept 20, 2010) Attachment A, 2-3: ‘the prohibition against references to ratings in regulations under section 939A goes further than is reasonably necessary to respond to these issues. Rather than disregard credit ratings, it may be more appropriate to assess their strengths and weaknesses and to supplement ratings with additional analysis in appropriate cases. We suggest that section 939A be amended to direct regulators to require that ratings-based determinations be confirmed by additional risk analysis in circumstances where ratings are likely to present an incomplete picture of the risks presented to an institution, or where those risks are heightened due to concentrations in particular asset classes’.


26 CFTC, ‘Removing any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings’ (November 2010) Proposed Rules, Federal Register Vol 75 No 211.
939A, two groups of CFTC regulations are of relevance: 1) those regulations in which credit ratings are used to limit Commission registrants’ investments or deposits of customer funds; and 2) those regulations which require disclosing a credit rating to describe the characteristics of an investment, namely, Regulation 1.49 and Regulation 4.24. Before the CFTC review, Regulation 1.49 regarded a foreign depository as acceptable where it had in excess of $1 billion of regulatory capital or issue commercial paper, or a long debt instrument, rated in one of the two highest rating categories by at least one Nationally Recognised Statistical Rating Organisation (NRSRO). Under Section 939A of the Dodd-Frank Act, the second alternative referring to the credit ratings should have been removed and replaced with another standard for the measurement of creditworthiness. Indeed, the CFTC initially proposed the elimination of such a reference and sought consultation on whether it could be sufficient relying exclusively on a minimum capital requirement of $1 billion in regulatory capital, or whether another standard or measure of solvency and creditworthiness, different than external credit ratings, could be used as an appropriate, additional test of a bank’s safety. With regard to Regulation 4.24, the credit rating reference to be removed was identified in the requirement for CPOs to disclose the characteristics of the commodity and other interests that the pool will trade, including, where applicable, their investment rating. In this regard, the CFTC proposed to replace the reference to credit ratings with the phrase ‘creditworthiness’.

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27 CFTC, ‘Removing any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings’ (July 2011) Proposed Rules, Federal Register Vol 75 No 211.
28 17 CFR 1.49-Denomination of Customer Funds and Location of Depositories (2009).
29 CFTC (n 27).
31 CFTC (n 27): ‘the pool operator must disclose the following: 1) the types of commodity interests and other interests which the pool will trade, including: (i) the approximate percentage of the pool’s assets that will be used to trade commodity interests, securities and other types of interests, categorized by type of commodity or market sector, type of security (debt, equity preferred equity), whether traded or listed on a regulated exchange market, maturity ranges and creditworthiness, as applicable’.
In the first place, it can be noted that the CFTC’s only applied a removal of the credit rating reference. As mentioned above, the approach under Section 939A can be defined within the following stages: review, removal and alternatives. However, the CFTC’s work can only be assessed within the first two stages, that is, review and removal. It can be defined as a restyling of the two regulations through which credit rating references disappear, but no specific alternatives for them have been set out. Also, the CFTC’s approach maintains the possibility of relying on credit ratings. In essence, credit rating references are deleted from the CFTC’s regulations but they survive in practice. In fact, the CFTC acknowledges that CPOs will not be prohibited from relying on credit ratings. Rather, credit ratings can be used as one of the factors to be taken into consideration in making an investment decision.32

OCC

The second review to be analysed in chronological order is the final rule issued by the OCC in June 2012, which began to be effective as of January 2013. The amendments applied by the OCC pertain to those rules which list the requirements that national banks and Federal savings have to follow to determine whether or not a security is investment grade. The investment grade status is the condition upon which the purchase of a security is permissible. Prior to the amendments, securities could be regarded as investment grade where they were rated in one of the top four investment grade rating scales by two or one NRSROs. Should the security be unrated, the investment grade status could be determined by the national bank or Federal savings association regarding the debt instrument as having the same credit quality of a security rated investment grade by NRSROs.33 In this context the centrality of the role of the credit

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32 CFTC (n 26): ‘The Commission notes that the removal of references to ratings does not prohibit a DCO or FCM from taking into account credit ratings as one of many factors to be considered in making an investment decision. Rather the presence of high ratings is not required and would not provide a safe harbor for investments that do not satisfy the objectives of preserving principal and maintaining liquidity’.
33 See 12 CFR 1.5 (national banks) and 12 CFR 160.1(b) and 160.40(c) (federal savings associations).
ratings provided by NRSROs is evident. Not only were the credit ratings the sole determinant of the investment grade status, but also they were the reference parameter to which the national banks or Federal savings could base their investment grade determination.

Pursuant to the amendments set out in the OCC Final rule, a new definition of investment grade security is provided. Such is the security when its issuer has an ‘adequate capacity’ to meet financial commitments under the security for the projected life of the asset exposure. In substance, the definition of investment grade is consequent to an analytical process in which it must be determined: 1) that the risk of default by the obligor is low; and 2) that full and timely repayment of principal and interest is expected.

The OCC’s approach marks an evolution vis-à-vis the CFTC’s approach. While the CFTC’s review only led to a restyling of the legislation with no alternatives to credit ratings, the OCC based its standard on a new definition of investment grade to be determined by national banks and Federal savings. To this end, reference could be made to a variety of factors other than external credit ratings. However, the OCC did not specify any factor to be chosen as alternatives to the NRSRO credit ratings. Possible alternatives were generically indicated. These included the firms’ own internal systems or analytics provided by third parties, when conducting due diligence and determining whether a particular security may be permissible and considered an appropriate investment.35

**NCUA**

Further evolution in the elaboration of the standard of creditworthiness can be discussed in relation to the NCUA review, which is the third in chronological order. The NCUA conducted its review and found references to NRSRO credit ratings in parts 703, 704, 709 and 742 of the

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34 OCC Department of Treasury, ‘Alternatives to the Use of External Credit Ratings in the Regulations of the OCC (June 2012) Final Rule, Federal Register Vol 77 No 114.
35 Ibid.
NCUA regulations. Part 703 provides an interpretation of those sections of the Federal Credit Union Act specifying those securities, deposits and other obligations in which a Federal credit union (FCU) is permitted or prohibited to invest. On the other hand, part 704 provides a list of definitions of terms referring to the investment activities of corporate credit unions, while part 709 disciplines the involuntary liquidation of FCUs and the adjudication of creditor claims involving federally insured credit unions (FICUs). Finally, part 742 provides an exemption from certain regulatory restrictions for credit unions that have showed sustained superior performance.

All these parts have credit rating references which must be subjected to removal under Section 939A. For instance, under parts 703 and 704 some securities, rated in the highest category by NRSROs, meet the requirement of being permissible. Under part 709 a definition of securitisation which includes a reference to NRSROs is provided, while pursuant to part 742 a credit union can be exempted from the prohibition of purchasing a commercial mortgage related security provided that, among other requirements, the security is rated in one of the two highest rating categories by at least one NRSRO.

The NCUA’s approach is based on the evaluation of an issuer’s capacity to repay its debt. Consequently, a distinction is made between an issuer’s ‘adequate capacity’ to meet its financial obligations for the projected life of the security even under adverse economic conditions; and an issuer’s ‘strong capacity’ to meet all financial commitments under the security for its projected life even under adverse economic conditions. While the first standard

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37 12 CFR Part 703-Investment and Deposit Activities.
38 12 CFR Part 704-Corporate Credit Unions.
39 12 CFR Part 709-Involuntary liquidation of federal Credit Unions and Adjudication of Creditor Claims Involving Federally Insured Credit Unions in Liquidation.
40 12 CFR Part 742-Regulatory Flexibility Program.
41 See 12 CFR Part 703.2; 12 CFR Part 704.2.
42 See 12 CFR Part 709.10(a)(5).
43 See 12 CFR Part 742.4.
44 NCUA (n 36).
is labelled as ‘investment grade’, the second is referred to as ‘minimum amount of credit risk’.\textsuperscript{45} Having ‘adequate capacity’ to meet financial commitment is different than having ‘strong capacity’. The former entails more risk than the latter which finally implies a minimum amount of credit risk. In other words, both represent the likelihood of repayment of the debt. ‘Strong capacity’ means having a higher probability of repayment than ‘adequate’ capacity’. Consequently, the assessment of the ‘investment grade’ status requires more analysis and monitoring than the ‘minimum amount of credit risk’ status. This task will be on the corporate credit unions.\textsuperscript{46}

In this respect, the evolution of the NCUA approach, compared to the OCC, is marked by the specification of a series of factors which the unions can take into consideration for regarding a security as investment grade or as having a minimum amount of credit risk. The list is wide: credit spreads; securities-related research; internal or external credit risk assessment; default statistics; inclusion on an index; priority and enhancement; price, yield, and/or volume; and asset class-specific factors.\textsuperscript{47} Even though NRSRO credit ratings are not explicitly mentioned, there is an indirect reference to them as ‘an external credit risk assessment’.

**FHFA**

The work undertaken by the OCC and NCUA became the platform upon which the other agencies have or are currently developing their own standards to comply with Section 939A of the Dodd Frank Act. At the time of writing, the FHFA has issued its proposal for removing credit rating references and substituting them with opportune alternative standards of creditworthiness in its regulations.\textsuperscript{48} In this respect, the source is the Federal Home Loan Bank

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\textsuperscript{45} Ibid.  
\textsuperscript{47} Ibid.  
Act (Bank Act) which regulates the operation of twelve, wholesale cooperative banks whose members are entitled to purchase the capital stock of a bank and obtain access to secured loans. Some provisions of the Bank Act make reference to external credit ratings to the extent that they prohibit the cooperative banks to invest in securities rated below ‘investment grade’ by NRSROs at the time the investment is made.49 Furthermore, other provisions allow the banks to invest in debt instruments issued by state, local, or tribal government units or agencies, having the second highest credit rating assigned by NRSROs.50

Under the current proposal brought forward by the agency, these credit rating references could be substituted through a new standard, namely ‘investment quality’. Such a standard would replace references to ‘investment grade’ certified by NRSROs and ‘second highest credit rating from an NRSRO’. Consequently, a permissible security to be invested in would no longer be the one rated investment grade by CRAs, but the one which can be regarded as having ‘investment quality’. This status is the result of a determination made by banks. In essence, under the FHFA’s proposal, banks may be required to assess that there is adequate financial support for any debt instrument or obligation, so that the repayment of principal and interest is guaranteed and, hence, there is only minimal risk that such payment would not be serviced because of adverse events during the life of the instrument.

Like in the NCUA approach, this assessment can be made by taking into consideration a wide variety of factors: internal or external credit risk assessments, including scenario analysis; security or asset-class related research; credit analysis of cash flow and debt service projections; credit spreads; loss distributions, default rates, and other statistics; relevant market data, for example, bid-ask spreads, most recent sales price, and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the investment; local and regional economic conditions; legal or other contractual implications to

49 12 CFR 1267.3(a)(3).
50 12 CFR 1267.3(a)(4)(iii).
credit and repayment risk; underwriting, performance measures and triggers; and other financial instrument covenants and considerations. Significantly, the credit ratings are no longer the exclusive benchmarks to be referred to, but they are still a factor to be taken into consideration.

**US banking agencies**

The establishment of a new definition of creditworthiness based on repayment capacity and risk of default is the paradigm which has been finally applied by the US Banking agencies. This results in the final rule that the OCC and the Board of Governors of the Federal Reserve System (Board) have jointly adopted to revise their risk based and leverage capital requirements for banking organisations. To comply, *inter alia*, with Section 939A of the Dodd-Frank Act the final rule has elaborated a new standard of creditworthiness based on a definition of investment grade which does not rely exclusively on external credit ratings. Specifically, ‘investment grade’ was a status that the entity to which the banking organisation was exposed through a loan or security was required to have. This could be determined through a top credit rating assigned by NRSROs.

Under the final rule, investment grade are those entities which are deemed to have ‘an adequate capacity to meet financial commitments for the projected life of the asset or exposure’. The entities’ capacity to meet financial commitments is regarded as adequate if their risk of default is low and the full and timely repayment of principal and interest is expected. This standard of creditworthiness has also been applied by the Federal Deposit Insurance Corporation (FDIC) while revising its own risk-based and leverage capital requirement for FDIC supervised institutions. The FDIC has acknowledged that its final rule is identical to the

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51 FHFA (n 48), 4.
52 Ibid.
joint final rule issued by the OCC and the Board. Consequently, the FDIC has referred to the investment grade status defined by these agencies to comply with Section 939A.53

SEC

The SEC is also involved in the review process directed through Section 939A. The standards elaborated currently are concerned with some rules incorporated in the Investment Company Act (ICA). In chronological order, the first relevant change has been applied to section 6(a)(5) of the ICA.54 Prior to the recent amendments, under this section business and industrial development companies (BIDCOs) could only purchase securities rated investment grade by NRSROs. The investment grade certification provided by NRSROs would allow BIDCOs to benefit from some exceptions set out in other rules of the ICA.55 Consequently, the review entails the removal of such reliance. To this end, the standard elaborated is based on the qualification of securities having ‘moderate credit risk and sufficient liquidity’. Therefore, BIDCOs can benefit from the exceptions by purchasing securities which the board of directors or members of the BIDCOs determine to be a) subject to no greater than moderate risk and b) sufficiently liquid so that the security can be sold within a reasonably short period of time. This determination is made at the time of purchase and the board of directors or members of the BIDCOs are allowed to refer to credit quality reports prepared by outside sources, including NRSROs, which are regarded as credible and reliable for the indicated purpose.56

Minimum credit risk and sufficient liquidity are also applied to rule 10f-3 of the ICA. Rule 10f-3 permits the purchase of securities (such as municipal securities or debt instruments which are offered privately to institutional investors) that are not registered under the Securities

53 Ibid.
56 SEC (n 54).
Act. An investment grade rating provided by NRSROs was the condition to be met to regard these securities as a permissible investment under rule 10f-3.\textsuperscript{57} As aforementioned, the SEC applied the same creditworthiness standard, which was elaborated on section 6(a)(5), based on a degree of liquidity so that the security can be sold within a reasonably short period of time and subject to a minimal or low amount of credit risk.\textsuperscript{58}

Furthermore, a new standard alternative to external credit ratings can be illustrated in relation to rule 5b-3. Before the amendments, under rule 5b-3 a repurchase agreement could be regarded as fully collateralised where, among others, the collateral for the repurchase agreement consisted entirely of cash items, government securities, securities rated in the highest rating category by NRSROs or unrated securities whose quality was comparable to securities that are top rated by NRSROs.\textsuperscript{59} This determination was the task of the fund’s board of directors or its delegate. In relation to this rule, the standard of creditworthiness alternative to the external credit ratings is again a determination aimed at assessing a sufficient degree of liquidity permitting the debt instrument to be sold at a reasonable time and an issuer’s capacity to meet its financial obligation on the securities collateralising the repurchase agreement. In this respect, the wording of the SEC refers to an issuer’s ‘exceptionally strong capacity to meet its financial commitments’. In this context, it is specified that the board can reach the credit quality and liquidity determination through an analysis which can take into consideration third-party assessments, including an NRSRO rating.\textsuperscript{60}

Finally, the SEC applied amendments to those provisions of rule 15c3-1, requiring broker dealers to refer to NRSROs’ credit ratings as objective criteria to determine whether they could deduct less than the standard 15% safety margin, or ‘haircut’ from the market value of

\textsuperscript{57} 15 U.S.C. 80a-2(a)(3)(A, (B) and (C).
certain debt instruments. According to the new standard of creditworthiness, elaborated as an alternative to external credit ratings (and to allow the application of lower haircuts), broker dealers are required to elaborate policies and procedures designed to assess the credit risk applicable to the position.\textsuperscript{61} Such an analysis must lead to the determination that the investment has only a ‘minimum amount of credit risk’. Broker dealers can determine this status by using a variety of factors, such as: credit spreads, securities-related research, internal or external credit risk assessments, default statistics, inclusion on an index, priorities and enhancements, price yield and/or volume and asset class-specific factors. It cannot be left unnoticed that external credit ratings, though they are no longer exclusive credit risk assessment tools, did not disappear and can still be referred to.\textsuperscript{62}

\textbf{DOL}

The SEC’s standards of creditworthiness are also the source upon which the DOL is currently elaborating its own reforms. Reference is to be made to the Employee Retirement Income Security Act (ERISA), which includes provisions of the Internal Revenue Code (the Code), the Federal labour laws and other Federal laws.\textsuperscript{63} The prohibited transaction rules of the Code fall under the jurisdiction of the DOL. In this respect, the DOL has set out a number of generic or ‘class’ prohibited transaction exemptions (PTEs), many of which apply to party-in-interest transactions involving securities. The DOL has regarded some of its class exemptions as regulations which fall under the scope of Section 939A.\textsuperscript{64} To this end, the proposed review is addressing PTE 75-1, PTE 80-83, PTE 81-8, PTE 95-60, PTE 97-41 and PTE 2006-16. All the

\begin{flushleft}
\textsuperscript{61} 17 CFR 240.15c3-1
\textsuperscript{64} DOL, ‘Proposed Amendments to Class Prohibited Transaction Exemptions to Remove Credit Ratings Pursuant to the Dodd Frank Wall Street Reform and Consumer Protection Act’ (June 2013) Federal Register Vol 78 No 120.
\end{flushleft}
listed regulations are concerned with the purchase or sale of securities by employees or fiduciaries on behalf of employees and provide relief from the restrictions that the ERISA apply to the purchase or sale. Among the conditions to be met, in order to be granted exemptions, the regulations require investment grade credit ratings be provided by NRSROs.

By way of referring to the standard of creditworthiness elaborated by the SEC in relation to rules 10f-3, and 5b-3 of the Investment Company Act, the DOL is proposing to replace the credit rating references in its PTEs in the same way. Therefore, ‘minimal or low amount of credit risk’ as well as ‘highest or exceptionally strong capacity’ to meet obligations are the parameters the DOL is likely to apply to its regulations. Again, the approach is based on eliminating the primacy of credit ratings in regulations. However, this does not mean prohibiting credit ratings since the DOL, in the same way as the other agencies, intends to refer to them as among one the factors to be taken into account for the assessment of creditworthiness.65

3. The US reforms: a critical review

Evaluating the work of the agencies

Before the illustrated amendments, external credit ratings were the main parameters for measuring creditworthiness. In light of the changes applied by the agencies, credit ratings are now among several factors to be taken into consideration. This principle characterises all the proposed and final rules that the US regulators have issued so far. All the agencies’ approaches mark the end of the primacy of the external credit ratings in legislation and regulatory frameworks. This aspect stimulates numerous reflections.

65 Ibid: ‘The Department recognizes that, where a fiduciary has neither the expertise nor the time to make an informed determination of credit quality, it may be appropriate as a matter of prudence for such fiduciary to seek out the advice and counsel of third parties. Furthermore, it should be noted that, while credit ratings may no longer serve as a basis, or threshold, of credit quality, section 939A of Dodd-Frank does not prohibit a fiduciary from using credit ratings as an element, or data point, in that analysis’.
In relation to the spirit and letter of Section 939A, the new role of credit ratings, no longer as the exclusive tool, but one tool among others to be considered for determining the standard of creditworthiness elaborated by each agency, might mean that Section 939A does not prohibit credit ratings as initially feared by the users of credit ratings. The agencies themselves had to finally underline that this is not the purpose of the Dodd Frank Act, in particular, Section 939A. Other than being the authentic interpretation of Section 939A, this aspect may be discussed from a practical perspective, namely in relation to the impossibility of finding proper, universally accepted, alternatives to credit ratings. In fact, the CFTC, the OCC and the NCUA stressed that they did not receive any indication from the users of credit ratings in this respect. Their main concern was only in relation to the prospect of being prevented from using the credit ratings through the implementation of Section 939A. Significantly, the initial criticism against the formulation of Section 939A and the fear expressed by the users of credit ratings during the consultations launched by the agencies turned out to be a strong defence of the credit ratings against a complete removal.

Hypothetically, if a universally accepted alternative to the credit ratings had been found and tested, it may be sensible to think that the credit ratings might not have been indicated among other factors to be taken into account for credit quality assessments. However, not only has ‘the’ alternative ever been found, but also the unanimous opposition by the users of the credit ratings played a decisive role in making the proposed and final rules. At this stage, it can be asserted that Section 939A initially pursued the elimination of the credit ratings from legislation and regulatory frameworks. Then, the final result of this strategy through the work of the mandated agencies denotes a diversion from this aim. Rating-based regulation is a word

66 NCUA (n 36): ‘A number of commenters stated that the proposal went beyond the requirements of the Dodd Frank Act…..The NCUA Board notes that nothing in the NPRM prohibited credit unions from using credit ratings as an element of the required credit analysis’.
67 See CFTC (n 26): ‘Only one commenter discussed ratings. BlackRock cautioned that complete removal of ratings criteria as a risk filter may place undue responsibility on an FCM or DCO to complete a thorough risk assessment of an issuer’s financial strength’.
which still fits in the new context. Whereas previously the regulation was ‘exclusively’ based on the credit ratings, now it is ‘also’ based on the credit ratings. This is sufficient to say that the credit ratings remained and hence they are still part of the legislation. The proposed or final rules set out by the US agencies reflect a middle-of-the-road solution in an attempt to comply with the letter of Section 939A, satisfy the users of the credit ratings, and find other credit risk assessment tools to be indicated together with the credit ratings with a view toward eliminating their exclusivity in legislation, but not their presence.

This can find confirmation through the work that the agencies have completed so far. For example, taking position from the CFTC’s and NCUA’s explanations of their respective amendments, some interesting elements can be found in support of the assertion that the agencies’ work was challenged by the utopian aim to find a unique, universally accepted alternative to the credit ratings, and by the influence that the users of the credit ratings exercised in favour of them. To begin with the CFTC, this agency explained the removal on the grounds that it noted the poor past performance of the credit ratings in gauging the safety of certain types of investments. Accordingly, their reference in the Commission’s regulations is no longer essential to assess the creditworthiness of some investments. However, the CFTC’s final rule also stated that FCM or DCO may refer to external credit ratings as one of many factors to make an investment decision.68 There is a clear contradiction. If credit ratings are no longer useful or necessary due to their past performance, why would FCM or DCO still be entitled to refer to such useless or unnecessary credit risk assessment tools? This contradiction could have been avoided where an alternative credit risk assessment tool had been discussed, but, as mentioned above, the CFTC did not receive any external comment or proposal. The NCUA, instead, received some proposals. In its final rule it specified that one commentator suggested including the credit spreads as an alternative standard for measuring creditworthiness. Nonetheless, the

68 Ibid.
NCUA had reservations as to the opportunity to replace one standard with another.\(^6\) It appears that none of the agencies took any responsibility in deciding or proposing a specific credit risk assessment tool, which should have replaced the credit ratings. This explains why Section 939A set up a plan that was finally too challenging.

To put it more simply, while a review and removal of credit ratings is possible, it is not possible to get rid of the credit ratings completely. This also justifies the choice of setting out a list of alternatives to be freely selected by the market participants. In substance, the NCUA’s decision not to give exclusiveness to the credit spreads as alternatives to replace credit ratings mirrors what all the agencies have pursued or have been aiming to pursue in their current or next final rules. Specifically, the NCUA said that they would not include credit spreads as an exclusive standard of creditworthiness, but the market participants are free to refer to them if they find them useful for their credit risk assessment analysis. This is not different from the way through which the other agencies finally dealt with the credit ratings: they cannot refer to them as exclusive benchmarks but the ratings can be selected among other tools and used by the market participants. All things considered, the credit ratings’ primacy in US legislation has been reduced, but they have not been totally eliminated.

Looking ahead

The work of the US agencies gives an important message in relation to the policy of tackling the phenomenon of investors’ over-reliance through the elimination of credit rating references in legislation and regulatory frameworks. In theory, the primacy of credit ratings can be reduced in two ways: by eliminating completely credit ratings through a valid alternative or by referring

\(^6\) NCUA (n 36), 3: ‘the NCUA Board does not support this approach because credit spreads are a function of open markets and they reflect investor interest for reasons that include, but are not limited to, credit risk. Market credit spreads for various asset classes experience variability depending on current supply and demand for the product, actual market interest rates, and a variety of other factors. While the NCUA Board declines to establish specific allowable credit spreads, it notes that FCUs and corporates may use credit spread information as a factor in assessing changes in creditworthiness’. 

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to them along with other credit risk assessment tools. The latter solution has been definitely adopted by the US federal agencies because of the impracticability of the former. Where the purpose of the review is to find ‘one’ alternative to replace credit ratings, this will be challenging for a number of reasons. Not only this alternative should work better than the credit ratings but should also find wide consensus so that it is worth relying on it in place of credit ratings. Besides, such an approach should weigh carefully the extent to which the risk of over-reliance may shift from credit ratings to a new credit risk assessment tool. Consequently, elaborating a general standard of creditworthiness to be assessed through a variety of tools, including credit ratings, appears to be a mandatory solution due to the difficulties in fulfilling the requirements of the first option.

At the EU level, the review work that the ESAs completed at the end of 2014 under Article 5(b) of CRA Regulation III mirrors the difficulties that the US Federal agencies experienced while implementing Section 939A. Setting aside the EIOPA, which did not find any critical credit rating reference in its guidelines, recommendations and draft technical standards, the EBA and ESMA came to different conclusions. The EBA selected some credit rating references in its 2010 Revised Guidelines on the Recognition of External Credit Assessment Institutions but concluded that no amendments would have been applied due to, among other reasons, the difficulties in finding valid alternatives to credit ratings. On the other hand, the ESMA applied some amendments which were in line with the approach of the US Federal agencies to list credit ratings among other credit risk assessment tools. Specifically, changes were applied to the guidelines providing a definition of money market funds by stating

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72 Ibid, 16: ‘even if there is over-reliance, this cannot be corrected by any action of the ESAs, such as amending or repealing the guidelines, both for policy reasons (there is no available or agreed alternative), and for legal reasons (in the European Union, the guidelines/recommendations or delegated legislation and implementing measures cannot amend the CRR)’. 25
that a debt instrument’s investment grade quality should be determined by referring, *inter alia*, to credit ratings.\(^7\)

The review work of the ESAs and, above all, the overall approach adopted by the US Federal agencies to implement Section 939A can be an adequate platform to reflect over possible amendments to legislation and regulations in which credit ratings are referred to as exclusive credit risk assessment tools. In particular, the way the US regulators have implemented Section 939A of the Dodd-Frank Act may give significant information as to the review work and identification of alternatives to credit ratings that the Commission is expected to complete by 2020 under Article 5(c) of CRA Regulation III.\(^7\)

In essence, the US experience is teaching that there is a stark contrast between eliminating regulatory reliance on credit ratings and reducing regulatory reliance on credit ratings. The first implies eliminating credit ratings from legislation and substituting them with an alternative; the second implies maintaining credit ratings in legislation and creating a level playing field between them and other credit risk assessment tools. In the US, the initial aim was to eliminate regulatory reliance, but they finally opted to reduce regulatory reliance on credit ratings.

4. **Conclusion**

Through the implementation of Section 939A of the Dodd-Frank Act, the US has made interesting progress in the reduction of credit rating references in legislation and regulatory frameworks to address investors’ and market participants’ over-reliance. The approach to list credit ratings along with other tools for assessing the credit quality of debt instruments marks

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\(^7\) Ibid,17: ‘Where one or more credit rating agencies registered and supervised by ESMA have provided a rating of the instrument, the management company’s internal assessment should have regard to, *inter alia*, those credit ratings’.

\(^7\) Recently, the Commission has launched a consultation as to possible alternatives to credit ratings, see, ‘Call for Tender MARKT/2014/257/F for a study on the feasibility of alternatives to credit ratings and the state of the credit rating market’ <http://ec.europa.eu/finance/rating-agencies/index_en.htm>.
the end of the exclusivity that the US regulators have always given to credit ratings in their legislation and regulations. However, the present analysis has shown how the US Federal agencies were not able to completely delete credit ratings from their legislation. Thus, the standards of creditworthiness under the final and proposed rules issued by the Federal agencies depart from the initial purpose of Section 939A.

The adopted solutions can influence the current and future review work that the FSB jurisdictions are undertaking to implement the FSB two-pronged approach. In particular, the US experience teaches that thinking of deleting credit ratings from legislation to substitute them with another alternative is not feasible. There is not yet a valid, universally accepted, alternative to credit ratings. Consequently, it is fœrger to indicate a variety of risk assessment tools and give investors and market participants the freedom to choose the one they think is more useful for their credit risk assessment and due diligence.

If this can become, on the basis of the US experience, the global approach to reducing the risk of investors’ over-reliance derived from the presence of credit ratings in legislation, the effectiveness of this approach in achieving that outcome remains to be evaluated. The fact that credit ratings are listed among other tools for assessing creditworthiness implies considering the extent to which they can remain, in practice, the primary tool chosen by the market participants vis-à-vis the others. In this case, it should be questioned whether the risk of over-reliance is still concrete despite the reduction of credit rating references in legislation.

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