

The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social, educational, economical, and consumer issues both on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.

Re: Public Consultation on Credit Rating Agencies/European Commission, Directorate General Internal Market and Services

Statement of opinion by the Austrian Federal Chamber of Labour

General introduction

The spectacular failure of the practice of formal use of ratings for the judgment of credit risks can only be understood as the result of a long process during which the character of ratings was subject to a fundamental change, which, however, remained largely unnoticed. Originally, the outsourcing of collecting and evaluating information on debtors was a means of reducing the cost of this service. In this „innocuous“ form, it still exists in Austria and in Germany as „Auskunftei“. But this is totally different from the function which ratings issued by the principal rating agencies have today. Bank regulation laws have elevated ratings to formally or de-facto obligatory judgements (“sentences”) which are more or less uniformly binding for banks and other financial institutions, with severe negative consequences.

- Through this uniformity which is enforced also by standardized contract clauses rating agencies act as “cheerleaders” of movements of irrational exuberance, with its inherent abrupt switches from extreme optimism to extreme pessimism. The changes of ratings themselves follow the changes of sentiments prevailing in financial markets, through the uniformity of their application, and thus increase volatility of asset prices.
- This is exacerbated by the fact that serious misjudgements (starting with Enron, to be topped by good ratings for the “innovative” real estate securities which were seriously flawed at the moment of issuance) which were corrected only after bankruptcy had occurred further weakened the credibility of financial markets. From the spectacular cases of failure one could well draw the conclusion that, where ratings would be helpful, they are wrong, and in the other cases they are unnecessary.
- Even worse, through discriminatory ratings US territorial authorities were forced to insure their securities with monolins.
- With respect to decision making in banks and financial institutions, ratings have functioned as final element of the “system or organized irresponsibility” that has become an essential characteristic of corporate decision making. By elevating the ratings of the three leading agencies to the status of quasi-official judgements of creditworthiness and risk, banking laws have in fact alleviated corporate executive boards of a major part of their responsibility by shifting it to the rating agencies, which, however, are not – and cannot realistically be – liable for misjudgements. In the end, nobody was responsible for

the misjudgements which eventually lead to the catastrophic breakdown of world financial markets.

Therefore, the flaws in the regulatory framework of the financial system, to the extent that they relate to the function of rating agencies, call for measures with respect to the fundamental role which ratings can and cannot play in financial markets.

Question 1 Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?

With respect to big corporate enterprises, the reference to ratings in formal contract clauses, with automatic consequences, should be prohibited, and legally declared ineffective.

Question 2 How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?

In case of small and medium sized firms, banks, if they have a longer term relationship to their creditor clients, often have more knowledge and better information than external institutions to judge credit risks. Hence, both external and internal ratings can be helpful.

Question 3 Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?

No.

Question 4 What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?

Contra: high volatility; market dependency abuse and market disturbances

Question 5 Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed?

Yes, we strongly agree.

To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?

The restrictive effect would be considerable, but it is necessary in order to reduce risks.

Question 7 Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?

Yes, we strongly agree. Reference to external rating should not be accepted as sufficient argument for investment decisions.

Question 9 *To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in their investment policies, risk management processes and in investment mandates?*

The use is by far too extensive

Question 11 *Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?*

Basically: yes

Question 12 *Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?*

See the introductory text: such clauses should be prohibited in principle; otherwise the elevated role of ratings will persist. Only under the condition that ratings have less quasi-official power, that is, if ratings can be used as waterproof justification of an investment decision.

Question 13 *Should investment managers be obliged to introduce measures to ensure that the proportion of portfolios that is solely reliant on external credit ratings is limited? If yes, what limitations could be considered appropriate? Should such limitation be phased in over time?*

See the introductory text.

Question 15 *What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates*

As a matter of principle, any a priori exclusive reliance on external ratings should be prohibited. Reference to external rating should be declared unacceptable and insufficient as justification of investment decisions made by corporate executives.

Questions 16-18 *What is your opinion regarding the ideas outlined above? How can the transparency and monitoring of sovereign debt ratings be improved?*

Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?

Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?

Ideas proposed in the Commission's paper are supported in principle.

Questions 19 -22 *What is your opinion on the need to introduce one or more the proposed measures?*

More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?

Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?

What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

None of these proposals is likely to have any significant effect. On the other hand, there would not be undesirable effects either.

Question 23 How could new players be encouraged to enter the credit rating agency sector?

The belief that more competition among rating agencies would reduce the inherent negative effects of the functioning seems unjustified. The users of ratings have an interest in uniformity; they have no interest at all in a greater variety that would increase the burden of responsibility for investment decisions. The expectation that a great variety of available ratings would reduce the importance of rating agencies and would help to deprive them of their elevated status is most probably unjustified.

Question 24 Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions?

Yes, but the problem of liability of the ECB in case of false ratings must be faced and solved. A similar problem arises in the context of question 25

Question 25 Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?

Question 26 Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level?

No.

Question 27 Is there a need to create a new independent European Credit Rating Agency? If so, how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit rating agency? What are the potential advantages and disadvantages of this approach?

See question 23.

There is little reason that a private "European" rating agency would be in any respect different from existing agencies in its functioning.

Question 31 Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?

Yes.

Question 32 *If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?*

The main consequence would be the risk of bankruptcy (like Arthur Anderson), and that could have some effect.

Question 33 *Should such a potential liability regime cover solicited as well as unsolicited ratings?*

Yes.

Question 34 *Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?*

Yes.

Question 35 *What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the "issuer-pays" model? If so please indicate which alternatives appear to be the most feasible ones and why.*

Only option a contains some promise. The best option is No. 2, because there is a stronger incentive for rating agencies to carefully analyse the fundamentals, to think in a longer time horizon and to include fat tail risks.