

Table of Contents

Abbreviations	19
I. Introduction	21
A. Background	21
B. Concerns over Ratings' Regulatory Function in the Institutional Investment Context	22
1. Regulation of Rating Over-Reliance in Asset Management	22
2. Credit Rating Downgrades as Threat to Financial Stability	23
3. Investment Guidelines as Subject of Regulation and Supervision	24
C. Research Questions	25
D. Methodology and Approach	25
II. Regulation of Credit Ratings as Subject of Research	29
A. Emergence, Economic Function and Characteristics of Credit Ratings	29
1. Historic Development	29
2. Ratings as Intermediated Market Information	30
(i) Role of Creditworthiness Information for Financial Markets	30
(ii) Function of Credit Rating Agencies as Information Intermediary for Market Participants	32
3. Market for Intermediated Financial Information as Structural Determinant	33
4. Credit Ratings Agencies within the Efficient Market Hypothesis	35
5. Credit Ratings between Transaction and Information Markets	36
6. Summary	38
B. Characteristics of Credit Ratings and Credit Rating Agencies within Information System of Capital Markets	38
1. Assessment of Default Probability	39
	9

2. Third Party Role between Emitter and Investor	40
(i) Subjective Third-Party Opinion	40
(ii) Relative Grading of Creditworthiness	41
(iii) Symbolical Expression of Credit Rating	43
3. Characteristics of the Credit Rating Industry	44
(i) Investor Pays vs. Issuer Pays Model	44
(ii) The Rating Process: Solicited vs. Unsolicited Ratings	46
4. Rating Objects	48
(i) Issuer Rating	48
(ii) Issuance Rating	49
(a) Bonds	49
(b) Structured Financial Products	50
(c) Preferred Stock	51
(d) Sovereigns	51
5. Summary: Credit Ratings as Universal and Subjective Third-Party Opinions on Credit Risk	52
C. The Regulatory Function of Credit Ratings	53
1. Regulation of Banks – Basel I, II & III	53
2. Regulation of Market Access	55
3. Regulation of Institutional Investors	56
(i) Insurances & Pension Funds	57
(ii) Money Market Funds	58
(a) US Money Market Funds	59
(b) EU Money Market Funds	60
4. Private Rulemaking as a Distinct Regulatory Use Case	61
(i) Debt Contract Triggers	62
(a) Types of Debt Contract Rating Triggers	62
(b) Implications of Debt Contract Rating Triggers	63
(ii) Rating-Based Risk Limits and Strategies within Investment Mandates	64
(iii) Summary: Credit Ratings' Regulatory Function with Evident Trigger Effects	65
D. Financial Crises as Initiators for the Regulation of Ratings and Rating Over-Reliance	65
1. The Role of Credit Ratings in Corporate and Sovereign Crises	66
(i) East-Asian Financial Crisis	66

(ii) Corporate Bankruptcies: Enron and WorldCom	67
(iii) The 2008 Financial Crisis – Structured Finance and Sovereign Debt	69
(a) US Residential House Financing – Mortgage- Backed Securities and Collateralized Debt Obligations	69
(b) Wide-Ranging Rating Downgrades Following Collapse of US Housing Market	71
(iv) Sovereign Rating Downgrades as Crisis Contagion	72
2. Alternating Views on the Role of Credit Rating Agencies	74
(i) Cognitive Biases and Skewed Incentives	75
(ii) Parallels in Proposed Policy Implications	77
3. Failure of Credit Rating Agencies	79
(i) Flawed Rating Processes and Models as Source of Error	79
(ii) Inaccurate Ratings as Result of Flawed Models and Processes	81
4. Misconceptions of Credit Ratings’ Meaning – Rating Over-Reliance	82
5. Structural and Situational Determinants of Downgrade Consequences	84
(i) Structural Implications of Debt Markets	84
(ii) Market Timing Implications	85
(iii) Contagion through Credit Rating Agencies’ Rules	87
(iv) Liquidity Squeeze Resulting from Sell-Offs	88
6. Summary: Consequences to Downgrades Following Ratings’ Failed Information Function Fortified through Rating Over-Reliance and Disadvantageous Structural and Situational Determinants	90
III. Regulating Ratings’ Regulatory Function – The Case of Rating Over-Reliance within Mutual Fund Investment Guidelines	93
A. Regulation of Credit Rating Agencies’ Information Function in the US and Europe	94
1. IOSCO Code of Conduct and Reputation	95
2. Regulation and Liability of CRAs in the US	96
(i) Credit Rating Agency Reform Act of 2006	96
(ii) Dodd Frank Act of 2010	97

3. Regulation and Liability of CRAs in the EU	98
4. Summary	101
B. Empirical Evidence for Price Impact of Investment Limits	102
1. Market Segmentation through Rating Defined Investment Limits	103
2. Evidence for Synchronizing References to the Investment Grade Boundary	105
C. Rating Over-Reliance and its Regulation	107
1. Empirical Evidence as Rationale for Regulation beyond Credit Rating Agencies' Information Function – Price Movements around Rating Changes	108
(i) Results of Studies on Bond, Credit Default Swaps and Stock Prices	109
(ii) Strong Price Movements around the Investment-/ Non-Investment Grade Barrier	111
(iii) Significance of Market Reactions of Solicited and Unsolicited Ratings	112
(iv) Market Reactions in Advance of Rating Changes	113
(v) Stronger Market Reactions to Downgrades Compared to Upgrades	114
2. Market Impact of Regulatory Forced Sell-Offs: The Segmentation of Markets and Synchronizing Effects of the Investment Grade Barrier	115
(i) Market Segmentation through Rating-Based Investment Limits	115
(ii) Investment Grade Barrier as Synchronizer of Rating-Based Rules	116
3. Summary: Material Informational Value Inexplicable by the Semi-Efficient Market Hypothesis and Need for Regulation of Forced Sell-Offs with Focus on Investment Grade Barrier	117
D. Over-/Mechanistic Rating Reliance: Terminology and Financial Context	118
1. Regulation of Rating Over-Reliance	119
(i) US Approach to Reduce Rating Reliance: Early Initiatives and Dodd Frank	120

(ii) Role of the Financial Stability Board	121
(a) Content of Financial Stability Board Guidelines	123
(b) Implementation of Financial Stability Board Guidelines into European Law	123
(1) CRA III	124
(2) Non CRA III initiatives	125
2. Summary: Orchestrated and Wide-Ranging Initiatives to Reduce Rating Reliance within the US and Europe	126
E. Reducing Rating Over-Reliance in Investment Management	127
1. Rationale for Collective Investments & Significance of Asset Management	127
2. Potential Forced-Sell Offs through Downgrades in Investment Management	128
(i) Money Market Funds	128
(ii) Investment Grade Index Funds	131
(iii) Debt Mutual Funds	133
(a) Collateral Downgrades	133
(b) Counterparty Downgrade	134
(c) Downgrade through Investment Guideline Minimum Risk Boundary	136
F. The Regulation of Rating Over-Reliance within Mutual Fund Investment Guidelines	138
1. Historic Emergence of Investment Guidelines for Mutual Funds	138
2. Investment Fund Governance – Managing the Principal Agent Relationship	140
(i) Discretion, Moral Hazard and Economic Incentives	141
(ii) Governance of Collective Investments	143
3. Emergence and Driver of Credit Rating References in Investment Guidelines	144
G. Regulatory and Supervisory Efforts to Reduce the Over- Reliance on Ratings within Investment Guidelines	147
1. Introduction of KAGB §29 (2a) on the Basis of CRA III Article 5a	148
2. Amendments to Investment Act of 1940 Following Section 939 of Dodd Frank	150

3. Responses by EU and US Supervisory Authorities to FSB Stocktaking	151
(i) Response by German Financial Market Authority BaFin	152
(ii) Response by the SEC	153
4. IOSCO Good Practices as Additional Guiding Principles to Reduce the Reliance on Ratings in Investment Management	154
(i) Demand of Individual Credit Risk Assessments & Communication of Downgrade Procedures	155
(ii) Access to Underlying Credit Rating Information	156
(iii) Disclosure on Uses of External Ratings	156
(iv) Quality of Counterparties and Collateral	157
(v) Managing External Credit Rating Changes	158
(vi) Investor Reliance on External Credit Ratings	158
(vii) Summary: Confirmation of Ratings' Market Relevant Role within Investment Guidelines & Proposals for Adjustment	159
5. The Joint Committee of EU Supervisory Authorities' Good Practices for Reducing Mechanistic Reliance on Credit Ratings	160
(i) General Joint Committee Good Practices	161
(ii) Specific Joint Committee Good Practices	161
6. Comparative Summary of IOSCO and Joint Committee Good Practices	162
IV. Empirical Analysis of Mutual Fund Investment Guidelines	165
A. Rationale for Empirical Analysis	165
1. Prior Studies on the Role of Ratings within the Investment Guidelines of Mutual Funds	166
(i) Pre-Crisis Survey Study by Cantor, Thomas and Gwilym	166
(ii) Text Recognition Study on US Mutual Fund Investment Guidelines	169
2. Need for Comprehensive Empirical Review of Status-Quo	170

B. Empirical Research Questions	171
1. Do mutual fund investment guidelines pose a source of mechanistic rating reliance that can trigger forced sell-offs in a downgrade scenario?	172
2. Is there a consistent approach between US and EU issued documentation to address mechanistic rating reliance?	172
3. What constitutes non-mechanistic investment guidelines?	172
4. Which implications derive from investment guidelines that do not mechanistically rely on external credit ratings?	173
C. Empirical Scoring Model	173
1. Model Requirements	173
2. Three Step Scoring Model	173
(i) Score Computation Structure	174
(ii) Screening Process and Data	175
(iii) Model Data – Requirements and Sources	177
(a) US Fund Database	177
(b) E.U. Fund Database	178
3. Model Variables	178
(i) Variable 1: Jurisdiction of Offering	179
(ii) Variable 2: Size of Asset Management Firm	179
(iii) Variable 3: Investment Objective	181
(a) European Investment Objectives	181
(b) US Investment Objectives	182
4. Model Structure	183
(i) Group 1: Determinants of Rating Reliance	184
(ii) Group 2: Divestment Controls	185
(iii) Group 3: Divestment Alleviating Factors	188
D. Empirical Model	193
1. Determining the Appropriate Econometric Methodology	193
2. Statistical Analysis of Results – Mann Whitney U-Test	195
3. Hypothesis Based Test Procedure	195
E. Hypothesis Testing of Score Results	196
1. Hypothesis 1: There is no significant reliance on credit ratings.	196

2. Hypothesis 2: Mutual funds will not be forced to sell-off portfolio positions following a rating downgrade below the investment grade boundary by either S&P, Moody's or Fitch.	197
3. Hypothesis 3: There is equal rating reliance between mutual fund prospectuses issued in the EU and the US.	198
4. Hypothesis 4: Large asset management firms are less reliant on external ratings compared to smaller firms	199
5. Hypothesis 5: Mutual funds categorized as "Investment Grade" funds are on average more reliant on external ratings.	201
6. Hypothesis 6: Mutual funds categorised as High Yield and Specialised Funds rely, on average, less mechanistically on external ratings compared to other all funds.	202
7. Hypothesis Testing of Criteria Datapoints	203
(i) Structure of the Two-Sample Z-Test	204
(ii) Rating Reliance Criteria and Jurisdiction	204
(iii) Rating Reliance Criteria and Fund Size	207
F. Answers to Research Question, Additional Findings and Discussion of Results	209
1. Answers to the Empirical Research Questions	210
(i) Do mutual fund investment guidelines pose a source of mechanistic rating reliance that can trigger forced sell-offs in a downgrade scenario?	210
(ii) Is there a consistent approach between US and EU issued documentation to address mechanistic rating reliance?	213
(iii) What constitutes non-mechanistic investment guidelines?	216
2. Additional Findings and Considerations	217
(i) Lack of Rating References and Contract Elements as Source of Low Rating Reliance	217
(ii) Varied Results by Hypotheses Tests on Firm Size and Fund Type	218
(iii) Non-Expressive Results from Differentiation between Fund Size and Reliance Categories	219

(iv) Characteristics of Non-Mechanistically Rating Relying on Investment Guidelines	219
3. Implications Deriving from Investment Guidelines that Do Not Mechanistically Rely on External Credit Ratings	219
(i) Theoretical Drawbacks to Elements of Divestment Controls	220
(ii) Implications Deriving from Theoretical Drawbacks of Divestment Controls	221
4. Discussion on Conflict between Investor Protection and Enablement of Market Functioning	222
5. Robustness Test and Comparison with Empirical Results in Light of Findings from Previous Studies	222
(i) Decline in Role of Internal Risk Assessments	223
(ii) Uncertainty over Share of Rating-Based Investment Guidelines	224
(iii) No Utilisation of Rating Outlooks or Watchlist Conditions	225
(iv) Fewer Retention Clauses than Stated in 2007	225
(v) Equal Share of Proportionate Rating Definitions	226
(vi) Confirmation of Results on US funds	227
(vii) Concluding the Comparative Review of Empirical Findings	228
(v) Relative Positioning to Previous Studies	229
V. Summary and Conclusion	231
VI. Appendix	237
A. Empirical Database	237
1. List of EU Funds Analysed (Table 9)	237
2. List of US Funds Analysed (Table 10)	242
B. Empirical Model Structure (Table 11)	248
C. Result Visualization	250
1. Reliance Score Distribution (Figure 2)	250
2. Immediacy Score Distribution (Figure 3)	250
Bibliography	251