

## Annex VI

### Use of Ratings in the Regulatory Process

The 1990s have witnessed an increased reliance on credit ratings by regulators in both mature and emerging markets. Indeed, the ratings are used in rather similar fashions in all countries. Perhaps the most extensive use of ratings has been to place investment restrictions on regulated institutions (Tables A6.1 and A6.2). Another common regulatory use of ratings relates to establishing capital requirements for financial institutions.<sup>1</sup> Various countries impose lower capital ratios for banks and haircuts on securities houses when they hold highly rated securities. A third area of use relates to disclosure and issuance requirements. Initially, disclosure requirements for issuers of investment-grade securities were reduced. Subsequently, regulators specified that certain types of securities could only be issued if rated, and they often imposed a minimum rating requirement on these issues. Most regulators in emerging markets in Asia and Latin America currently impose a rating requirement on issues of nongovernment bonds and commercial paper. Self-regulatory bodies such as stock exchanges in the United States and Europe also impose rating requirements that issuers have to fulfill in order to be listed.

Most regulators stipulate a list of recognized agencies whose ratings can be used to satisfy ratings requirements. In Japan, for example, the ministry of finance has maintained a list of designated Japanese and American ratings agencies since 1986.<sup>2</sup> In the United States, such agencies are referred to as Nationally Recognized Statistical Rating Organizations (NRSROs), a term introduced by the SEC in 1975.<sup>3</sup> To resolve the ambiguity created by multiple and, at times, different ratings, most regulations accept the highest or second-highest

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<sup>1</sup> The recent proposal on capital adequacy requirements by the Basel Committee on Bank Supervision to use credit rating to determine risk weight is reviewed in Box 4.2, Chapter IV.

<sup>2</sup> The list today consists of the following agencies: Japan Rating and Investment Information, Japan Credit Rating Agency, Moody's Investors Service, S&P's, Fitch IBCA, DCR, and Thomson Bank Watch.

<sup>3</sup> The list of NRSROs in the United States includes the major agencies (Moody's, S&P's, Fitch IBCA, DCR, Thomson Bank Watch) as well as some smaller ones (McCarthy, Crisanti). Several foreign rating agencies have applications pending with the SEC to acquire NRSRO status.

**Table A6.1. U.S. Regulations Making Use of Credit Ratings**

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1. The Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) have, since 1936, restricted banks to investing in investment-grade debt securities.
2. The Federal Deposit Insurance Commission (FDIC) does not allow insured banks that are not members of the Federal Reserve System (FRS) to acquire or establish subsidiaries that trade in securities, but there are a few exceptions, such as if the securities are investment grade. The FDIC also imposes on state-chartered banks that are not members of the FRS to mark to market non-investment-grade securities in capital valuations.
3. The National Association of Insurance Commissioners (NAIC) established in 1951 capital requirements for insurance companies that give the lowest requirement ratio to investment grade debt securities.
4. A 1975 amendment to rule 15c3-1 of the Securities and Exchange Commission (SEC) specifies the percentage haircut deductions that apply to broker-dealers' investment-grade bonds depending on their type. The securities that receive the lowest haircuts include commercial paper rated in one of the three highest rating categories by at least two NRSROs and nonconvertible debt securities rated in one of the four highest rating categories by at least two NRSROs.
5. Since 1982, the SEC has simplified information disclosure for issuers of investment grade securities who are allowed to register their securities using form S-3. Also, foreign issuers are automatically eligible to use the simple form F-2 to register investment grade securities. An even simpler form, F-3, is also available for use under specific conditions, some of which are relaxed, however, if the security to be registered is investment grade.
6. Since 1989, the Department of Labor has permitted pension funds to invest in asset-backed pass-through certificates if, among other conditions, these certificates are rated in one of the three highest categories by one of the four largest rating agencies.
7. Under the Financial Institutions Recovery and Reform Act of 1989, savings and loans are prohibited from investing in non-investment-grade securities.
8. Under the 1991 amendment to rule 2a-7 of the 1940 Investment Company Act (ICA), money market funds are required to limit investments to securities that are rated in one of the two highest rankings by at least two NRSROs (and only up to 5 percent of investments should be in securities rated in the second rating, while only up to 1 percent of assets can be second-rating securities of a single issuer).
9. Under rule 3a-7 of the 1940 ICA, adopted by the SEC in 1992, certain issuers of asset-backed securities are exempt from registration and regulation if, among other factors, their issues receive investment-grade ratings by at least one NRSRO.
10. Underwriting of nonconvertible debt or nonconvertible preferred stock is allowed under rule 10b-6 of the SEC 1934 Act when the securities involved have an investment-grade rating from at least one NRSRO.
11. Under rule 10f-3 of the 1940 ICA, registered investment companies cannot engage in underwriting activities if the underwriter is an affiliate or an affiliate of an affiliate. One exception to that rule, however, is if the company is acquiring investment-grade municipal bonds.
12. Under rule 12d3-1 of the 1940 ICA, the rules under which an investment company can acquire securities of parties deriving more than 15 percent of their gross revenues from securities-related activities include a rating requirement: the acquired securities have to be investment grade.
13. Some rules imposed on savings associations registered with the Office of Thrift Supervision make use of ratings. These associations, for example, cannot trade in corporate debt securities that are not investment grade, nor in commercial paper rated below the first two highest ratings by an NRSRO, and both types of assets can qualify as liquid to meet liquidity requirements.
14. Foreign banks that want to insure their deposits with the FDIC are required to pledge a specific percentage of high-quality assets such as securities rated in one of the two highest ratings by an NRSRO.
15. Several states use credit ratings in security valuations and in ruling on the type of investments eligible for various state-regulated

funds and financial institutions. In California, county treasurers can only invest in money market funds that are rated by two NRSROs, and municipalities can invest up to 30 percent of their portfolio in medium-term corporate bonds if they have a minimum A rating by two NRSROs. In Vermont, domestic issuers can invest a maximum of 50 percent of their assets in investment-grade fixed-rate corporate securities, banks can invest in investment-grade interest paying corporate securities and in revenue bonds issued by out-of-state parties if they are rated investment grade.

16. The New York Stock Exchange and Philadelphia Stock Exchange set margin requirements based on the type of security pledged to secure the loan. The most favorable treatment is accorded to U.S. government obligations and to mortgage-backed debt securities rated in one of the two highest rating categories by at least one NRSRO (NYSE rule 431 and PHLX rule 722).

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Sources: Baron and Murch (1993); Cantor and Packer (1994); Dale and Thomas (1991); conversations with representatives of the SEC and various credit rating agencies.

**Table A6.2. Regulatory Use of Credit Ratings in Selected Countries**

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**Industrial Countries**

Australia	Although there are no nationwide regulations making use of ratings, the provinces of New South Wales and Victoria restrict fiduciaries to invest only in securities that have a stipulated rating (AA or higher in the first province, varying depending on the rating agency in Victoria)
Canada	More simple filing procedures apply when issuing nonconvertible debt or preferred stock in the case of companies that already have investment-grade outstanding debt. A credit rating is required from banks when their financial condition is being examined.
Japan	The ministry of finance stipulates that any listed company can issue commercial paper provided it has an investment-grade rating from two recognized agencies. Securities purchased, bonds borrowed, and financial instruments serving as collateral in repos undertaken by money reserve funds must be rated either long-term in the three highest rating classes or short-term in the two highest rating classes by at least two designated agencies. Investment in Class 1 securities (rated in the two highest long-term ratings or in the highest short-term rating) cannot exceed 5 percent of net assets per issuer (except for Japanese government and government-guaranteed issues) while investment in Class 2 securities cannot exceed 5 percent of total net assets, with a single issuer limit of 1 percent of net assets. The ministry of finance imposes on Japanese companies that want to issue nonconvertible (convertible) euroyen debt to either be rated AA (A) or above, or be rated A (BBB) and have net assets of 55 billion yen. Nonresidents can issue euroyen bonds provided they possess a rating.
Switzerland	To be listed for trading on the Zurich stock exchange, debt securities must be investment grade (or designed by the underwriter as equivalent).
E.C.	The Capital Adequacy Directive (CAD) was adopted in 1993, whereby a higher capital requirement was recommended for investment firms and credit institutions that hold low-grade securities.
France	The European CAD was adopted in 1996: the banking rule 95-02 allows for lower capital provisions for securities given at least two accepted minimum ratings by separate agencies. The rule specifies 13 acceptable agencies and a benchmark minimum rating for each. Commercial paper issues with maturities exceeding two years, asset-backed securities, and all bank certificates of deposits must be rated. The Stock Exchange can request a rating from any issuer that seeks a listing, and usually does so for first-time foreign issuers.
Italy	The European CAD directive was adopted in 1997: banks can reduce capital provisions for qualified securities, which are securities that have two approved ratings by two separate accepted agencies. The methodology followed by banks to determine the percentage deduction of own funds in the prudential provision for country risk takes into account ratings in addition to spreads. A securitization law, currently with the parliament, states that securitized assets of banks have to be rated. Money market funds cannot invest in paper rated below investment grade.
United Kingdom	The European CAD directive was adopted in 1996. Banks and securities firms are permitted lower capital provisions for investment grade securities.

## Emerging Markets

### Asia

- India** The Reserve Bank of India requires that loan and investment companies have minimum investment grade rating in order to accept public deposits. Also, the amount of such deposits that equipment leasing and hire purchase companies can accept is 2.4 times greater if they have such a rating. Nonbank financial corporations that are either unrated or rated below investment grade must disclose their rating to potential depositors before getting their deposits. Ratings are compulsory on all public issues of debentures with maturity exceeding 18 months. Hence, there is a rating requirement for nongovernment bonds, commercial paper, nonbank and bank deposits, and investment schemes of plantation companies. There are two requirements for large issues (exceeding the equivalent of \$25 million). Pension funds can only invest in securities that have two ratings.
- Indonesia** There is a minimum rating requirement on commercial paper issues (A4, the local minimum investment-grade rating) and a rating requirement on nongovernment bond issues. The insurance council "urges" companies to invest in investment-grade paper, and is currently proposing to use ratings as part of a system of risk-based capital provisioning for insurance companies.
- Korea** There is a requirement of two ratings for the issuance of nongovernment bonds and commercial paper but under discussion is the possibility to remove this requirement. The ministry of finance and economy looks at the ratings of bonds of security companies in determining net capital rules.
- Malaysia** There is a minimum rating requirement (BBB, which is the local equivalent of investment grade) on nongovernment bonds and commercial paper.
- Philippines** There is a rating requirement for nongovernment bond issues, and the security and exchange commission there has the discretion to mandate a rating for commercial paper issues. The social security, retirement, and separation benefits systems can only invest in commercial paper rated investment grade. The national health insurance corporation can only invest in the stock of companies with debt rating of investment grade.
- Taiwan** There is a rating requirement on nongovernment bonds.
- Province of** Financial institutions that guarantee commercial paper programs must be rated.
- China** Any issuers of warrants or guarantors of warrants must be investment grade rated. Corporate bonds can be deposited with the central bank (as collateral, for example) by investment trust companies only if these bonds have been rated in the lowest A level. Issuers of bonds and stocks are allowed accelerated procedures if within the past 12 months they issued debt rated investment grade. The central bank gives credit in banks' risk-adjusted capital calculations to holdings of debt securities rated above investment grade.
- Thailand** The limit imposed by the Bank of Thailand on bank lending to a single borrower (25 percent of the bank's Tier 1 capital) does not apply in case the bank is acting as an underwriter of securities issued by a company with a AA or higher credit rating. There is a rating requirement on nongovernment bonds and commercial paper publicly sold.

## Latin America

- Argentina** Banks must be rated by two separate agencies and have to disclose these ratings to counterparties in a transaction upon demand. In addition to banks, most types of financial institutions are subject to a rating requirement as well—except for insurance companies. Banks capital adequacy requirements are lower for loans granted to clients with ratings above the sovereign as well as for OECD government bonds rated investment grade. Liquidity requirements of banks can be met with holdings of various securities issued by A-rated firms or financial institutions. Banks cannot purchase bonds issued by (or extend credit to) related clients if these bonds are rated below BB. Banks are required to issue bonds for 2 percent of deposits, to be held by a foreign bank with an A rating or higher.
- Chile** The issue abroad of American Depository Receipts by residents is subject to two minimum international risk-rating requirements (BBB- for banks; BB- for other firms). The sale or issue abroad of bonds or other debt securities by resident banks and firms registered with the Superintendency of Securities and Insurance is subject to a minimum rating requirement of BB- for nonfinancial institutions (BB if the bonds have less than 4-year maturity) and of A+ (BBB- in the case of subordinated bonds) for banks and financial institutions. Investment by commercial banks and other credit institutions abroad is restricted to bills and bonds issued or guaranteed by foreign governments or central banks and private enterprises with a minimum long-term international debt-risk rating (and its equivalent for short-term debt) of BBB. Pension funds and insurance companies may hold only foreign instruments of a minimum rating of A-. A credit rating is required from banks when their financial condition is being reviewed.
- Mexico** Private pension funds can only invest in securities rated at least AA. Firms must have an investment-grade standing when they issue debt. There is one rating requirement on all debt (commercial paper, medium-term notes and bonds) issued by companies in the public market. Debt funds have to be rated. The Superintendency of pension funds requires pension funds to be rated, but the ratings are private (only disclosed to the regulators and to the funds themselves), although there is a possibility that they will be made public soon.

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Sources: Banco Central de Argentina (1998); Baron and Murch (1993); Callen and others (1998); Dale and Thomas (1991); Laurens and Cardoso (1998); IADB (1998); World Bank (1998); and conversations with central bank and ministry of finance officials and with representatives of various credit rating agencies.

rating. Most countries that assign a list of recognized agencies accept the ratings of the major international institutions (such as S&P's and Moody's) and those of some local agencies.<sup>4</sup>

The United States pioneered the regulatory use of ratings some seven decades ago. In 1931, the OCC first used the distinction between investment- and non-investment-grade securities when it ruled that, while bonds rated BBB or better were to be carried at book values by banks, lower-rated bonds had to be written down to market value and 50 percent of the resulting losses were to be charged against capital. In 1936, the OCC and the Federal Reserve Board prohibited banks from holding bonds not rated investment grade by at least two agencies.<sup>5</sup> The use of the investment- and non-investment-grade distinction to constrain institutional portfolio choices subsequently spread, particularly in the late 1980s and the early 1990s, to pension funds, savings and loans, and money market funds (see items (6), (7), (8), and (13) in Table A6.1).

The use of ratings soon expanded to areas other than investment restrictions. In the early 1950s, insurance company regulators were using ratings to help determine the capital to be set aside when certain types of securities were held. In 1975, the SEC started imposing higher haircuts on broker-dealers holding commercial paper not rated in the three highest rating categories and for nonconvertible debt securities that were not investment grade.<sup>6</sup> In 1982, the SEC eased disclosure requirements for issuers of investment-grade securities, hence expanding the use of ratings to yet another new regulatory facet. This type of regulatory use was extended with the adoption of rule 3a-7 by the SEC in 1992, whereby an investment-grade rating for an asset-backed security allowed the issuer to use simplified registration requirements. The use of ratings subsequently expanded to use in regulation on underwriting activities (see items (10) and (11) in Table A6.1) and on restrictions related to the counterparts in security trading (see items (11) and (12) in Table A6.1).

The expanding use of ratings in regulation was also marked by a shift from the reliance on the investment-grade rating as a cut-off in rules. Alternative benchmarks became

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<sup>4</sup> The adoption of rating-based regulations was the main force leading to the creation of rating agencies in emerging markets in Latin America and Asia; there are on average three to four such agencies per country in Latin America. In cases where the establishment and operation of a rating agency are subject to a set of rules, as is the case in Argentina, Chile, and Mexico, once such an agency is allowed to be established, its ratings are automatically recognized by regulators.

<sup>5</sup> This investment-grade distinction was also adopted by the National Association of Insurance Commissioners in 1951.

<sup>6</sup> The SEC introduced at that time the concept of an NRSRO by referring to Moody's, S&P's, and Fitch as agencies whose ratings it recognized for the purpose of this legislation.

the A rating (adopted by the Department of Labor in restricting pension funds' investments as well as by the SEC in setting haircuts on commercial paper) or the AA rating (adopted by the Federal Deposit Insurance Commission in the conditionality attached to providing insurance to foreign banks' deposits as well as by the Office of Thrift Supervision in regulating the use of commercial paper both in trading and liquidity provisions by savings associations). Moreover, some regulations, instead of introducing a cut-off rating requirement, stipulated a schedule whereby various rating levels would correspond to different restrictions or charges. Hence, the SEC established different quantitative restrictions on the investments of money market funds depending on whether the securities are AAA or AA rated (see item (8) in Table A6.1).

Credit ratings were first introduced in Japan in 1974.<sup>7</sup> The first Japanese credit rating agency (Japanese Bond Research Institute) was established in 1979, and regulators began using its ratings as eligibility standards for bond issues in the early 1980s. By the 1990s, ratings completely replaced the previous standards for bond issuance based on net asset value and other firm data. Most of these extensive rating-based standards were in turn abolished in 1996, however, in a move to further liberalize financial markets. Nevertheless, the ministry of finance still relies on ratings in various ways, mainly in the prudential regulation of money reserve funds. These funds are not allowed to trade in securities rated below A (long-term) or AA (short-term). Issues of euroyen debt by domestic and foreign parties are subject to rating requirements as well (see Table A6.2).

In the mid-1980s, the regulatory use of ratings began to spread to countries other than Japan and the United States (see Table A6.2). In Europe, this trend was primarily promoted by the 1993 Capital Adequacy Directive, which specifies capital requirements designed to ensure the safety and soundness of banks and security houses in the European Community. The 1993 Capital Adequacy Directive stipulates that these institutions should set aside more capital against their holdings of non-investment-grade securities. By 1997, most EC member countries had amended their legislations to incorporate the 1993 Capital Adequacy Directive in their surveillance of financial companies. The traditional use of ratings in investment prohibitions recurred in Italy, where money market funds are not allowed to invest in low-grade paper. In France, rating requirements were imposed on the issuance of various types of securities, such as commercial paper, asset-backed securities, and bank certificates of deposits. The use of ratings in Europe, while still limited, is rapidly expanding. The recently proposed amendment to the Basel Capital Adequacy requirements, which links risk weights with ratings (see Box 4.2 in Chapter IV), is expected to lead to greater use of ratings in the regulatory process in all countries with internationally active banks.

The regulatory use of ratings in emerging markets, particularly in Latin America, has been fostered by the process of deregulation and liberalization. In some of these markets,

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<sup>7</sup> In 1974, Mitsui & Co. was the first Japanese firm to obtain a rating (BBB) from an American agency prior to launching an international bond offering.



capital requirements have been linked to the use of ratings. In Argentina, for example, bank capital requirements are lower for loans granted to clients with ratings above the sovereign, as well as for OECD government bonds rated investment grade. However, ratings are most widely used as benchmarks in restricting portfolio investment and security issuance. Rating-based investment restrictions are imposed on pension funds in Chile and Mexico, and on the social security and worker compensation systems in the Philippines. India, Indonesia, Korea, Malaysia, the Philippines, Taiwan Province of China, and Thailand figure among the countries that impose rating requirements on security issues. In Latin America, all countries except for Brazil either have already adopted rating-based restrictions on security issuance or are considering their use. Argentina, Chile, and Mexico have implemented rules requiring banks, financial companies, and debtors to be rated for a variety of reasons, including specifying conditions under which deposits can be accepted or debt can be issued (see Table A6.2).

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