The Use of Credit Ratings in Investment Management in the U.S. and Europe

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This study analyzes the results of a unique survey of 200 plan sponsors and investment managers in the U.S. and Europe regarding the use of credit rating rules and guidelines in the conduct of their investment activities. The survey results shed light on the way in which the principals (plan sponsors) rely on agency ratings to curb the risk taking appetites of their agents (investment managers). The study also investigates a number of important issues regarding the linkage between market dynamics and the use of credit ratings that, to date, have been the subject of theoretical conjecture or limited empirical evidence.

Some of the principal findings are that:

1. Contracts between plan sponsors and their investment managers include a wide variety of ratings-based guidelines that potentially affect portfolio investments, retentions, disclosures, and performance tracking.
2. Plan sponsors and investment managers generally incorporate ratings-based guidelines in their investment mandates at the suggestion of their governing boards, trustees, chief risk officers, or other people in their organizations that believe such guidelines promote sound investment practices. Importantly, regulatory requirements seem to play a relatively minor role in this regard.
3. Guidelines generally refer to specific rating agencies, rather than to agencies generically that may or may not be formally recognized by financial regulators.
4. The potentially destabilizing impact of ratings-based investment guidelines is mitigated by the wide variety of threshold rating levels referenced in contracts and the broad discretion generally given to investment managers when retention triggers calling for asset disposals are breached.
5. Despite the very different historical practices with respect to the reliance on ratings on the two continents, current practices and their motivations appear remarkably similar in Europe and North America.

A limited number of prior survey-based studies have investigated different aspects of the role of ratings and the agencies. Ellis [1998] highlights both similarities and differences between issuers and investors in relation to the role and interpretation of ratings. Baker and Mansi [2002] investigate attitudes to different rating agencies by both issuers and investors. Two studies by the Association of Finance Professionals [2002, 2004] report the views of senior finance professionals on the role of the SEC in regulating agencies, and on ratings' accuracy and timeliness. Duff and Einig [2007] build a model of ratings quality based on a survey of 400 U.K. issuers, corporate treasurers, investors, and other interested parties.

The article proceeds by introducing some background to the changing use of ratings and discusses some key issues before presenting our survey findings. We conclude with a discussion on policy implications.

BACKGROUND

Credit ratings have been used widely by investors since before the First World War and were incorporated into U.S. bank regulation in the 1930s. Regulators' use of ratings has expanded along with that of the private sector; today, they are an important part of the regulatory landscape in dozens of countries (e.g., see Annex VI in the IMF's International Capital Markets, September, 1999). In the U.S., there are currently over 100 federal laws and 50 regulations incorporating credit ratings. Dale and Thomas [1991] provide a unifying overview of the use of credit ratings in financial regulation and identify three general motives for their use by regulators: prudential aspects (aimed at financial soundness via minimum credit quality for portfolio holdings), investor protection (incorporating a minimum credit quality of security issuance), and enhanced market efficiency through raised awareness of the risk characteristics of securities.

In the wider financial market context, the rationale for the use of ratings usually boils down to two main points (see Gonzales et al. [2004]). Firstly, the informational advantage of economies of scale through the gathering and analysis of data relating to credit quality by the agencies, and the consequent reduction in adverse selection problems between issuers and purchasers of debt. Secondly, the monitoring role of ratings and the guidance they provide for economic agents in situations where it is difficult to observe the other party's actions, the so-called "principal-agent" problem.

Cantor [2004] explains that the purpose of ratings-based governance rules is to mitigate the problems that arise due to the different interests and incentives of investors and the portfolio managers they employ. Investors impose ratings-based portfolio governance rules on managers because limited liability leaves portfolio managers with insufficient incentive to avoid risk. Ratings-based governance rules are, presumably, common in the institutional money management sector because many investors do not want to evaluate individual credits and hire professional money managers to do that work for them. Recognizing, however, that investment managers may have an incentive to take excessive risk (due to the limited amount of their personal capital at risk), investors often require their managers to purchase only rated debt; indeed, they often require their managers to purchase and to hold only investment grade-rated debt. Moreover, they may require that they regularly report the rating distribution on their invested portfolio and compare investment returns to those on portfolios with similar credit rating characteristics.

In addition, it may well be the case that rating follow-ups help to resolve the moral hazard problem of once having issued "good debt," a non-rating agency monitored shareholder may be tempted to quietly increase business risk at the expense of the creditors. As a result of the above issues, ratings are increasingly used not only by regulators but also by banks, bondholders (via loan and bond covenants), pension fund trustees, and other fiduciary agents in the form of investment management guidelines; our survey concentrates on this latter activity.[1]

Credit ratings play an important role in portfolio governance, whether mandated by plan sponsors/trustees or through the initiative of the fund manager in the interests of good management practice. Our survey aims to shed light on the use of such rules in practice. In particular, we ask whether such portfolio guidelines are adopted to satisfy private sector needs or simply to satisfy regulatory requirements, and to investigate how such rules influence the reactions of asset managers to changes in credit quality in their portfolio.

Some Key Issues

Our survey allows us to examine several key empirical issues of interest to regulators and practitioners alike, including the so-called "hardwiring" of regulatory and market rules (including investment guidelines in the form of minimum quality thresholds), the trade-off between ratings' accuracy and ratings' stability, as heterogeneous users of ratings' information have different requirements, and the problem of "split ratings" as users make use of multiple agencies.

"Hardwiring" With regulators increasingly using ratings explicitly as a regulatory aid in dozens of countries, together with similar rules being adopted in a somewhat less formal or legalistic way by the investment management industry, the more different market participants use similar ratings-based rules or regulations, the more pronounced will be any reaction to certain credit events leading to possible illiquidity and distress. The major rating agencies are very much aware of the possible destabilizing aspects of rating triggers and encourage more disclosure of such mechanisms, though this is by no means complete.

The main danger of embedding ratings into investment rules and regulations is that it introduces predictability into the actions of market participants and, hence, increases the reaction of threshold effects; for example, as a bond moves from BBB– to BB+, i.e., below investment grade, many asset managers may no longer be allowed to hold it, leading to forced selling. The key here is that many market participants may be constrained by similar rules based on credit ratings and, hence, the more significant will be the market reaction.

Given the above observations, it would seem that a flexible response to such credit events by institutions is desirable in the interests of overall financial stability and the impact on the affected company's business and, indeed, there has been a trend of late to avoid automatic selling of downgraded assets and allowing portfolio managers some discretion both with respect to the timing of a disposal and its relation to overall portfolio credit quality. Our survey results support these observations.

Ratings stability versus ratings accuracy Rating agencies have generally aimed to provide credit assessments that remain roughly stable over the life of at least one business cycle, so-called "rating through the cycle." Some market participants may view this as inconsistent with timeliness and accuracy (see Association of Finance Professionals [2002, 2004]). Indeed, while the approach may be appropriate for the traditional customers of rating agencies, namely, bond issuers and investment management firms, a wider and more varied audience may require other attributes; for example, active investors including hedge funds or traders may be more concerned with shorter-term, more transient changes in perceived credit quality. Hence, the pressure has been on agencies to provide higher frequency credit assessments; this, to some extent, has been answered by their development of quantitative credit scoring "rating proxy" models, although banks have also developed their internal ratings based approaches which meet their needs to a larger extent.

However, there is a direct link between our discussion of stability and the "hardwiring" of ratings, since increased frequency of rating changes may interact with the rules to produce undesirable, destabilizing market outcomes, which could be reversed shortly afterwards as new information becomes available (though there is evidence of serial correlation in ratings changes, especially downwards). Of course, there is much evidence to relate credit risk to the business cycle (for e.g., Altman et al. [2005], Bangia et al. [2002]), despite rating agencies' specific desire to rate "through-the-cycle." Clearly, there may be a trade-off in the needs of different users of ratings: ratings stability may be seen as desirable by a "conventional" fund manager if it smoothes out cyclicality and random noise, i.e., offering an appropriately filtered signal which has removed transitory changes in credit fundamentals. Yet, agents who require a default probability assessment over a shorter horizon of, say, one year may find such smoothing inappropriate. Our survey throws light on practitioners' attitudes to this trade-off.[2]

Attitudes to split ratings With the expansion in the number of rating agencies throughout the world, the proliferation of rules and regulations using ratings, and the recent U.S. Senate hearings regarding NRSRO designation and related issues, users of multiple agencies are increasingly faced with so-called "split ratings," whereby two or more rating agencies disagree on an issuer's rating category, and a decision may have to be made over the choice of "preferred" rating. Barton [2006] offers an exhaustive global study of split ratings for all major international rating agencies, using a unique dataset of all issuer ratings back to 1989, published by FT Interactive Data, and finds systematic differences by region, industry, and agency. Cantor, Packer, and Cole [1997] explore how securities are priced when rating agencies assign different ratings. Ratings-based regulation such as Basle II provides guidance on the choice of rating in this context, but our survey offers insight into market practice where formal rules may not be present.

SURVEY RESULTS

In-depth telephone interviews were conducted with 50 fund managers and 50 trustees/pension plan sponsors each in the U.S. and Europe, making 200 data points in all. Among the European fund managers, 20 were based in the U.K., 13 in Germany, and the rest came from France, Denmark, Finland, Italy, Spain, Sweden, and Switzerland. Among the European plan sponsors, 18 were from the U.K., four were from Switzerland, and the remainder were distributed across the EU countries.

EXHIBIT 1A
Use of Ratings by Fund Managers

	Minimum rating requirements for bond purchases	Maximum portfolio shares by rating category	Maximum single security exposures by rating category	Downgraded securities that no longer meet eligibility guidelines	Benchmarking relative to ratings-based bond indices	Portfolio quality disclosures between managers and clients	Other (please explain):	Ratings are not explicitly referenced in investment guidelines
Panel A								
Total	76%	48%	50%	65%	37%	60%		14%
U.S.	74%	48%	54%	68%	42%	72%		12%
Europe	78%	48%	46%	62%	32%	48%		16%
Panel B								
Total								
Weighted Average Importance	1.359	2.459	2.972	3.176	3.231	3.950		
Rank	1	2	3	5	4	6		
U.S.								
Weighted Average Importance	1.586	2.375	3.125	3.043	3.000	3.583		
Rank	1	2	5	4	3	6		
Europe								
Weighted Average Importance	1.314	2.524	2.850	3.286	3.462	4.381		
Rank	1	2	3	4	5	6		

The questions involve the use of ratings in internal guidelines, together with motivations for their use. We shall take each question in turn in summarizing the results, before presenting an overall discussion of the issues that arise.

Q.1: *What use of ratings do plan sponsors explicitly make in investment contracts with fund managers, and what use do fund managers make of ratings in investment contracts with their clients? The relative importance of seven possible reasons (listed in Exhibit 1) should be ranked.*

For both plan sponsors and fund managers, the most widely cited use of ratings is in setting minimum credit quality guidelines for bond purchases, where around three-quarters of respondents in both the U.S. and Europe make such use of credit ratings. Otherwise, around half of plan sponsors and fund managers in both the U.S. and Europe use ratings to set maximum portfolio proportions by rating class, maximum single security exposures by rating category, and retention guidelines for downgraded securities that no longer meet eligibility guidelines. Interestingly, in the dialogue between fund manager and client, ratings are used far more in the U.S. than in Europe (Exhibit 1A). The absence of any ratings' guidelines is most prevalent among European fund managers (at 16%). In terms of weighted ranked importance, there is little substantive difference between the U.S. and Europe, or between plan sponsors and fund managers, with all parties unanimous in putting minimum rating requirements for bond purchases at the

Exhibit 1B
Use of Ratings by Plan Sponsors

	Minimum rating requirements for bond purchases	Maximum portfolio shares by rating category	Maximum single security exposures by rating category	Downgraded securities that no longer meet eligibility guidelines	Benchmarking relative to ratings-based bond indices	Portfolio quality disclosures between managers and clients	Other (please explain):	Ratings are not explicitly referenced in investment guidelines
Panel A								
Total	74%	49%	46%	57%	50%	48%		8%
U.S.	72%	42%	52%	56%	50%	44%		12%
Europe	76%	56%	40%	58%	50%	52%		4%
Panel B								
Total								
Weighted Average Importance	1.556	2.421	2.429	2.957	2.634	3.879		
Rank	1	2	3	5	4	6		
U.S.								
Weighted Average Importance	1.735	2.842	2.273	2.96	2.375	4.267		
Rank	1	4	2	5	3	6		
Europe								
Weighted Average Importance	1.345	2	2.692	3.952	2.833	3.556		
Rank	1	2	3	5	6	6		

top of their usage list, and portfolio quality disclosures at the bottom.

Separately, fund managers were asked a similar question irrespective of client requirements; perhaps unsurprisingly, almost identical results to Exhibit 1A were obtained, suggesting a degree of "comfort" in the relation between client and fund manager in this area of portfolio management (results available on request).

Q.2: What is the motivation for the uses of ratings in investment contracts?

Exhibits 2A and 2B show the range of alternatives offered. Fund managers use ratings largely because their clients require them to do so, in both the U.S. (62%) and Europe (56%), and rather less because regulations force them to do so (at around 20% each). Plan sponsors are driven somewhat less by "client" (i.e., supervising/advisory board) guidelines, at around 51% overall, and by regulation, at around only 4% for the U.S., compared to 20% for U.S. fund managers. There is a substantial element of herd behavior throughout (around 17% to 19% say they do it because most other managers do it), though a somewhat higher proportion do it because it is a good investment strategy, particularly in Europe where over a third of both plan sponsors and fund managers believe this to be the case.

Q.3: What rating categories are used in internal guidelines?

Exhibits 3A and 3B contain the response to this question. Over 90% of European fund managers use a

EXHIBIT 2A

Motivation for the Use of Ratings in Investment Contracts: Fund Managers

	Total	U.S.	Europe
Mandated by regulation	21%	20%	22%
Mandated by client	59%	62%	56%
Makes sense because most other managers do it	19%	14%	24%
Makes sense because it is a good investment strategy	25%	12%	38%
Mandated by our internal guidelines, irrespective of the client's preferences	31%	18%	44%
Ratings are not explicitly referenced in investment guidelines	14%	12%	16%

EXHIBIT 2B

Motivation for the Use of Ratings in Investment Contracts: Plan Sponsors

	Total	U.S.	Europe
Mandated by regulation	16%	4%	28%
Mandated by guidelines determined by our supervisory/advisory board	51%	56%	46%
Makes sense because most other plan sponsors do it	17%	20%	14%
Makes sense because it is a good investment strategy	29%	20%	38%
Ratings are not explicitly referenced in investment guidelines	8%	12%	4%

threshold of "A" and above in their guidelines, compared to around 76–80% in the U.S. The investment grade cut-off of Baa/BBB is equally used in both the U.S. and Europe at just under 90% of fund managers, whereas below investment grade ratings of B, Ba, and BB are used much more in the U.S. than Europe, at around 50% of managers, compared to under 40% in Europe.

Plan sponsors use high credit quality ratings of "A" and above more than U.S. fund managers, at around 85%, and more than European plan sponsors (at around 80%). The Baa/BBB investment grade threshold is less important to plan sponsors than fund managers (at 78% overall compared to 88%), while below investment grade ratings are used as internal guidelines much less frequently than by fund managers (around 25%, overall, compared to 42%+). Again, European plan sponsors are much less likely to use below investment grade rating guidelines than their U.S. counterparts. A related study of U.S. college endowments suggests that 75% of managers specify a minimum rating of Baa/BBB for purchasing bonds (Haight et al. [2006]).

The use of short-term rating guidelines is not as extensive as for long-term ratings. Over 60% of both plan sponsors and fund managers in the U.S. use the highest short-term rating classes, compared to 46% of European fund managers and 34% of European plan sponsors. The use of the lower quality P2/A2 is again dominated by U.S. fund managers (46% compared to 28% for Europe) and U.S. plan sponsors (30% compared to 16%). These results must be treated with caution as a high percentage of all sets of respondents did not know the answers; this was particularly the case with both European plan sponsors and fund managers.

Q. 4: Are investment guidelines using credit ratings based on one agency or multiple agencies?

Exhibits 4A and 4B show that, overwhelmingly, fund managers use multiple agencies in their internal guidelines, though a small percentage (6%) use a single agency.[3] Plan sponsors use explicit rating guidelines less extensively than fund managers, but around two-thirds

EXHIBIT 3A

The Use of Short- and Long-Term Rating Categories in Internal Guidelines: Fund Managers

	Total	U.S.	Europe
Panel A			
Aaa/AAA	86%	76%	96%
Aa/AA	86%	76%	96%
A/A	86%	80%	92%
Baa/BBB	88%	88%	88%
Ba/BB	45%	52%	38%
B/B	42%	48%	36%
None of the above apply	3%	4%	2%
No Answer	3%	4%	2%
Panel B			
P1/A1	54%	62%	46%
P2/A2	37%	46%	28%
P3/A3	15%	20%	10%
No Answer	44%	36%	52%

EXHIBIT 3B

The Use of Short- and Long-Term Rating Categories in Internal Guidelines: Plan Sponsors

	Total	U.S.	Europe
Panel A			
Aaa/AAA	83%	86%	80%
Aa/AA	82%	84%	80%
A/A	82%	84%	80%
Baa/BBB	78%	84%	72%
Ba/BB	26%	30%	22%
B/B	25%	30%	20%
None of the above apply	2%	-	4%
Ratings are not explicitly referenced in investment guidelines	8%	12%	4%
No Answer	6%	2%	10%
Panel B			
P1/A1	49%	64%	34%
P2/A2	23%	30%	16%
P3/A3	8%	6%	10%
Ratings are not explicitly referenced in investment guidelines	8%	12%	4%
No Answer	42%	22%	62%

EXHIBIT 4A
Fund Managers

	Total	US	Europe
Single Agency	6%	6%	6%
Multiple Agencies	92%	90%	94%

EXHIBIT 4B
Plan Sponsors

	Total	US	Europe
Single Agency	10%	6%	14%
Multiple Agencies	67%	68%	66%
Ratings are not explicitly referenced in investment guidelines	8%	12%	4%

use multiple agencies. There is no real difference between the U.S. and Europe in either category of rating user.

> **Q.5:** *Does the use of ratings' guidelines refer to rating agencies generically, officially recognized rating agencies, or specific agencies listed by name? If the latter case, which agencies are named?*

Exhibits 5A through 5D contain the answers to these questions. Listing agencies by name is the dominant approach by fund managers, particularly in Europe (80%). In the U.S, where the concept of NRSRO is widely recognized, 38% of guidelines refer to "officially recognized agencies," much greater than the 12% using this term in Europe. Of the specific agencies named, nearly all respondents referred to Moody's and Standard & Poor's in both Europe and the U.S., while around 70% referred to Fitch. There was occasional mention of Dominion Bond Rating Services, Capital Intelligence, A.M.Best, KMV (Moody's), Helix, and SRO (see also the Association of Finance Professionals [2002, 2004] surveys regarding the use of alternative credit rating agencies). One respondent also referred to internally generated ratings.

Exhibits 5C and 5D contain similar information from plan sponsors. Recall that the latter typically have made less use of ratings directly in internal guidelines and this is reflected by the higher proportion of no answers (which is virtually zero for fund managers). There is much less use of the term "officially recognized rating agencies" than by fund managers, at a mere 11% compared to 25%, and the use of specific agencies by name is around 60% with European sponsors, slightly above their U.S. counterparts, as with the fund managers. Exhibit 5D once again shows the dominance of Moody's and S&P in both the U.S. and Europe, with around 70% of sponsors listing them by name (far lower than the 98% of fund managers). Only around 30% listed Fitch as a specific agency, compared to over 70% of fund managers. Dominion Bond Rating Services were also mentioned, as was the use of internal ratings, particularly if Moody's and S&P do not rate a bond.

EXHIBIT 5A
Rating Agency Description in Internal Guidelines: Fund Managers

	Total	U.S.	Europe
Ratings agencies generically	9%	10%	8%
Officially recognized rating agencies	25%	38%	12%
Specific agencies listed by name	72%	64%	80%

EXHIBIT 5B
Rating Agency Description in Internal Guidelines: Fund Managers

	Total	U.S.	Europe
Moody's	98%	98%	98%
S&P	97%	96%	98%
Fitch	72%	74%	70%
Other	8%	10%	6%

EXHIBIT 5C
Rating Agency Description in Internal Guidelines: Plan Sponsors

	Total	U.S.	Europe
Ratings agencies generically	12%	12%	12%
Officially recognized rating agencies	11%	16%	6%
Specific agencies listed by name	58%	54%	62%
Ratings are not explicitly referenced in investment guidelines	8%	12%	4%
No Answer	11%	6%	16%

EXHIBIT 5D
Rating Agency Description in Internal Guidelines: Plan Sponsors

	Total	U.S.	Europe
Moody's	71%	72%	70%
S&P	71%	70%	72%
Fitch	31%	32%	30%
Other	12%	8%	16%
Ratings are not explicitly referenced in investment guidelines	8%	12%	4%
No Answer	10%	12%	8%

Q.6: *If more than one agency is used, what rules apply to the use of split ratings?*

Exhibits 6A and 6B contain the replies to this question. European fund managers are more cautious, with 55% opting to use the lower rating compared to only 22% in the U.S. Similarly, 16% of U.S. fund managers will use the higher rating, compared to only 4% in Europe. Very few (7%) will defer to a named agency, while nearly half will turn to a more subjective resolution involving a reference back to specific client preferences (about 40% of this group), an averaging process (about 20%), internal credit assessment (12%), or a case-by-case assessment (17%). A typical investment policy statement may read as follows: "Split rated debt shall be classified in the lowest rating of the major credit rating agencies" (see Haight et al. [2006]).

Plan sponsors follow similar general usage as fund managers (Exhibit 6B). 35% of U.S. sponsors will use the higher rating, compared to only 9% in Europe, while 48% of European will use the lower rating compared to 15% in the U.S. Very few (6%) will defer to a named agency, while once again a large number will consider matters on a subjective

EXHIBIT 6A
What Happens If There Are Multiple Ratings? Fund Managers

	Total*	U.S.	Europe
Use Higher Rating	10%	16%	4%
Use Lower Rating	39%	22%	55%
Use Specific Agency	7%	9%	4%
Variable / Depends	45%	53%	36%

EXHIBIT 6B
What Happens If There Are Multiple Ratings? Plan Sponsors

	Total	U.S.	Europe
Use Higher Rating	22%	35%	9%
Use Lower Rating	31%	15%	48%
Use Specific Agency	6%	6%	6%
Variable / Depends	36%	41%	30%

basis (36% overall); around 30% of this group will rely on consultants' or managers' discretion, and a similar proportion will look at issues on a case-by-case basis. A relatively small number (8%) will average the ratings.

Q.7: *What action is required when a security is downgraded and no longer meets the retention/eligibility requirements?*

The answers to this question are presented in Exhibit 7. Relatively few (4%) U.S. fund managers indicated that action would be taken within six months, compared to 16% of European managers (Exhibit 7A). Other than the roughly one in four of managers in both the U.S. and Europe who refer to client specific guidelines, there is no clear pattern in the reactions to a downgrade: 16% overall conduct an "internal review" while 18% refer to no "formal procedure." However, only in very few cases (6%) is the decision left to the managers.

A generally similar pattern unfolds for the plan sponsors in Exhibit 7B. While 26% of European plan sponsors insist on action within six months, only 4% of U.S. sponsors require this. The lack of general structure seen among fund managers is replicated here, with 10% overall pointing to "internal reviews" and 21% suggesting there is no "formal procedure." However, a big difference emerges with respect to "decision is with managers:" around 40% of U.S. plan sponsors defer to the investment manager when a rating guideline is broken, compared to only 20% in Europe. In contrast to these findings, Haight et al. [2006] report for U.S. college endowments that 75% of managers surveyed did not have a provision that deals with handling debt when the credit rating falls below the minimum investment criteria.[4]

Q.8: *Do plan sponsors and fund managers embed rating outlooks and/or watch list conditions in their investment guidelines?*

Exhibits 8A and 8B contain the answers to these questions. A relatively high proportion of plan sponsors (12%) were not familiar with rating outlooks/watch lists, and a majority do not use them and cannot foresee using them in the future: only 17% overall of plan sponsors include these features in their guidelines. On the other hand, 36% of European fund managers use them, compared to 24% in the U.S.; yet once again over half of all

EXHIBIT 7A
Action Required When A Security is Downgraded: Fund Managers

	Total	U.S.	Europe
Action is Taken Within 1 Month	4%	-	8%
Action is Taken Within 2-6 Months	6%	4%	8%
Must Sell Within an Unspecified Amount of Time	13%	20%	6%
Client Specific Guidelines	24%	26%	22%
Decision is with Managers	6%	2%	10%
Internal Review	16%	20%	12%
No Formal Procedure	18%	16%	20%

Exhibit 7B

Action Required When A Security is Downgraded: Plan Sponsors

	Total	U.S.	Europe
Action is Taken Within 1 Month	7%	-	14%
Action is Taken Within 2-6 Months	8%	4%	12%
Must Sell Within an Unspecified Amount of Time	10%	16%	4%
Client Specific Guidelines	6%	4%	8%
Decision is with Managers	30%	40%	20%
Internal Review	10%	10%	10%
No Formal Procedure	21%	18%	24%

fund managers do not use them and cannot foresee using them in the future. Only a very small number of fund managers were not familiar with the concepts. Hence, despite evidence (see Cantor and Hamilton [2004]) that rating outlook and watch list designations enhance the accuracy of the ratings, market participants do not use them in their guidelines.

***Q.9:** What is your preference between rating accuracy and rating stability, assuming that it is impossible to improve ratings' accuracy without reducing ratings' stability? (i.e., without increasing the frequency and magnitude of rating changes as well as the frequency of reversals of recent rating changes).*

Exhibits 9A and 9B contain the responses to this question. There is a general emphasis on accuracy over stability for both plan sponsors and fund managers (47% vs. 20%, and 60% vs. 22% respectively). A relatively small number of both (around 12%) thought the current balance was "about right." A common comment from both plan sponsors and fund managers is that ratings' instability is easier to handle than ratings' inaccuracy. Ratings' accuracy seems to be relatively more important for European fund managers and U.S. plan sponsors. For a further discussion of the trade-off between ratings accuracy and stability, see Cantor and Mann [2007]. Related survey

Exhibit 8A

The Use of Rating Outlooks/Watch Lists in Investment Guidelines: Fund Managers

	Total	U.S.	Europe
Yes	30%	24%	36%
No, but would consider in the future	15%	14%	16%
No, and unlikely to consider in the future	53%	60%	46%
Not familiar with rating outlooks and watch lists	2%	2%	2%

Exhibit 8B

The Use of Rating Outlooks/Watch Lists in Investment Guidelines: Plan Sponsors

	Total	U.S.	Europe
Yes	17%	14%	20%
No, but would consider in the future	15%	10%	20%
No, and unlikely to consider in the future	56%	60%	52%
Not familiar with rating outlooks and watch lists	12%	16%	8%

EXHIBIT 9A
Ratings Accuracy vs. Ratings Stability: Fund Managers

	Total	U.S.	Europe
Current balance is about right	13%	10%	16%
More emphasis on accuracy	60%	54%	66%
More emphasis on stability	22%	28%	16%
Don't Know / No Answer	5%	48%	2%

EXHIBIT 9B
Ratings Accuracy vs. Ratings Stability: Plan Sponsors

	Total	U.S.	Europe
Current balance is about right	12%	6%	18%
More emphasis on accuracy	47%	60%	34%
More emphasis on stability	20%	18%	22%
Don't Know / No Answer	21%	16%	26%

EXHIBIT 10A
Changes in Ratings' Use in Portfolio Guidelines: Fund Managers

	Total	U.S.	Europe
Increase	21%	12%	30%
Decrease	11%	10%	12%
No Change	64%	72%	56%
Don't Know / No Answer	4%	6%	2%

EXHIBIT 10B
Changes in Ratings' Use in Portfolio Guidelines: Plan Sponsors

	Total	U.S.	Europe
Increase	20%	10%	30%
Decrease	3%	-	6%
No Change	71%	84%	58%
Don't Know / No Answer	6%	6%	6%

evidence is presented in the Association of Finance Professionals [2002, 2004].

> ***Q.10:*** *Do you expect to increase/decrease your use of ratings to determine portfolio objectives or determine investment strategies? Give reasons.*

Exhibits 10A and 10B suggest that the major increase in use of ratings in internal investment guidelines by both plan sponsors and fund managers will come in Europe, where 30% of both categories see a rise in usage, some three times more than in the U.S. This is also reflected in a much larger proportion of both groups in the U.S. expecting little change. Of those fund managers expecting a decrease in ratings' use, about one half are moving to internal credit assessments, while the other half are moving to the use of credit spreads. Among those expecting an increase in ratings' usage, one third refer to the increased profile of Basle II and the "standardized" approach to credit risk, while a quarter believe their clients will require more use of ratings in the future.

DISCUSSION AND CONCLUSION

This survey is the first, to our knowledge, to provide a detailed investigation of U.S. and European attitudes to the important role of credit ratings in pension fund portfolio management and plan sponsor requirements.[5] It has been well documented in the past that regulatory use of ratings is increasing (Dale and Thomas [1991]), well founded in finance theory, and has been given a massive boost by the arrival of the standardized approach in Basle II and the European Capital Adequacy Directive. Yet our survey shows clearly that client requirements easily dominate regulatory needs in the use of ratings by investment managers (Exhibit 2). The greater familiarity of U.S. agents with credit ratings is revealed on a number of occasions: there is a much greater use of the investment grade cut-off point and below investment grade ratings by U.S. fund managers and plan sponsors than in Europe (Exhibit 3), while the understanding of the term "officially recognized rating agency" is much more prevalent in the U.S. (Exhibit 5). Most users require multiple agencies for ratings, usually by name, especially in Europe (Exhibit 5). Moody's and S&P dominate the named lists.

Where split ratings occur, the U.S. market participants are more likely to nominate the higher rating while Europeans defer to the lower one (Exhibit 6). Could this be due to different attitudes to risk or simply greater "comfort' with ratings" use in the U.S.? Indeed, could the difference in liquidity between U.S. and European bond markets lead to the use of lower ratings as a "safety first" device to proxy for their (perceived) illiquidity?[6] Similarly, when ratings guidelines are violated, Europeans insist on faster action than those in the U.S. (Exhibit 7). Relatively little formal use is made of ratings outlook/watch lists, which is surprising given the existing academic literature in this area (Exhibit 8). Generally, both fund managers and plan sponsors had a strong preference for accuracy over stability (Exhibit 9). The big growth area for ratings' use in portfolio management would appear to be in Europe, which is unsurprising given the maturity of the industry in the U.S. (Exhibit 10).

The list of uses for ratings guidelines is presented in Exhibit 1. Unsurprisingly, minimum credit quality guidelines are the dominant motivation, though maximum portfolio and security limits by rating class are also important. These findings apply to both fund managers and plan sponsors, emphasizing ratings' role in the principal-agent context.

Our findings have interesting insights regarding the issues raised in this article, and have policy relevance. The wide range of rating trigger levels (Exhibit 3), especially in the U.S., suggests that "credit cliffs" should be less an issue than may be expected despite widespread "hardwiring." As Europe gets more familiar with below investment grade ratings, we should see similar healthy developments there. Also Exhibit 7 reveals a flexible, reasoned response to downgrades and offers some comfort that the "hardwiring" of ratings in rules is less of a destabilizing force than may have been expected. Assuming that there is a trade-off between rating accuracy and stability, fund managers' preference seems to be for stability (Exhibit 9). However, based on our earlier discussion, we expect other types of agents to disagree.

From the standpoint of policy, a number of key points emerge: practitioners seem flexible in their response to downgrades in a way which is not destabilizing, though differences in U.S. and European attitudes to split ratings may be of more concern. Yet a mature and widespread use of ratings independent of regulations (Exhibit 2) suggests that participants fully appreciate the informational economies of scale and principal-agent issues. A growing use of, and familiarity with, ratings by European institutions would seem to be a likely outcome (Exhibit 10) which may well dilute the importance of investment grade rating triggers and possibly harmonize U.S. and European attitudes still further.

ENDNOTES

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[1]Cantor [2004] also suggests that ratings are used as tools for mitigating principal–agent problems in other areas within credit markets. For example, based on a borrower's credit rating, credit committees/credit officers often require varying levels of review before approving underwriter/loan officer recommendations. Moreover, lenders often offer borrowers more favorable terms if they are willing to commit to ratings-based covenants that trigger debt re-pricing, refinancing, or collateralization. Furthermore, some financial regulators vary capital requirements with the riskiness of an institution's assets, as measured in part by the credit ratings assigned to its investments.

[2]The enhanced power of Moody's ratings relative to market-based metrics at longer horizons is documented in Löffler [2004]. Differences in the accuracy and stability of credit ratings and alternative credit metrics are explored in Altman and Rijken [2004]. The shape of the frontier between accuracy and stability is examined in Cantor and Mann [2007]. Langohr [2006] discusses the power of fundamental ratings relative to market-based metrics with a detailed case study illustration.

[3]Baker and Mansi [2002] discuss the differing attitudes of investors and issuers regarding multiple ratings. They also find that 57% of investors surveyed only require one bond rating. The question they used clearly has a different focus to Question 4 above.

[4]For example, the University of Toronto pension scheme statement of investment policy (2006) states: "Should a debt security be downgraded below Baa/BBB subsequent to purchase, the investment manager will have complete discretion as to whether any remedial action should be taken."

[5]In the most closely related study, Haight et al. [2006] have recently discussed similar issues in the context of portfolio management by U.S. college endowments.

[6]We are grateful to Herwig M. Langohr for this observation.

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