TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

The Association of Corporate Treasurers

Comments in response to Consultation Report

The Role of Credit Rating Agencies in Structured Finance Markets

Technical Committee of the International Organization of Securities Commissions, March 2008

April 2008

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments. This document is on the record and may be freely quoted or reproduced with acknowledgement. The ACT welcomes the opportunity to comment on your consultation.

In this case we have consulted our membership through our credit ratings working group and our Policy and Technical Committee. Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf.

These comments are on the record and may be freely quoted with acknowledgement.

General

We welcome the opportunity to express views on this matter.

We comment from the point of view of non-financial corporations. Accordingly, we will comment directly on only a few of the consultation's proposals.

Comment

Corporate and sovereign ratings

In general we consider that corporate and sovereign ratings by the principal credit rating agencies ("CRAs") have worked well. It is important not to weaken this ratings sector in responding to issues arising in other ratings sectors.

Structured finance ratings

Rating designations: symbols

We consider that a simple suffix indicating a structured finance rating is desirable.

The function of credit ratings is to provide information about the opinion of the CRA about the rated obligations. The clearer the information, at reasonable cost, the more valuable the communication becomes.

It is important, therefore, that any rating scale used is not over-complicated and is both clear and widely understood.

An individual rating of an instrument/issuer has to be seen in two contexts:

- "Vertical" – the relationship with the rating of other similar instruments/issuers with higher or lower credit risk
- "Horizontal" – the relationship with the rating of other types of instrument/issuer.

The traditional vertical relationships in default probability indications, with their minor variations (AAA, Aaa, etc.), are quite well known and it would be unwelcome if this were to be changed.

Comparing ratings between risk types is more dangerous territory.

CRAs necessarily use different methodologies in rating different types of instruments/issuers and in subsequent monitoring. Here, this may mean that that a rating of a structured product can be qualitatively different from that of a corporate or sovereign security. If it is not obvious, this may be deduced, from CRAs' methodology descriptions.

Certain CRAs in rating money market funds[1] draw attention to the different methodology in rating and frequency and mode of monitoring by using a suffix letter – as AAAm, etc. – and this is very effective. We think that this provides a good model for structured credits.

So, the CRAs should consider appending a simple suffix for structured finance ratings, e.g. AAAsf, to guide investors and other market participants towards referring to the specific approach taken in evaluating the particular type of structured finance[2].

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[1] We refer to money market funds of the kind established under Rule 2a-7 of the United States Investment Company Act of 1940 and similar funds elsewhere.

[2] This must not be made over complex. As many types of structured financings can be invented, to try to give more detail in the rating symbol would nullify the "quick guide" nature of the basic symbol. If CRAs want to provide easy comparison between structured credits (reading published written research for several securities can take time), they can publish separate ratings of particular characteristics. That some CRAs publish separate "loss

Too many suffix types could weaken rather than improve the effectiveness of communication, of course. We do not see that problem with limited use of suffixes[3].

Other background comments

Independence and Avoidance of Conflicts of Interest

The "issuer pays" business model adopted by the main CRAs following the collapse of Penn Central, which seems at first glance to have inherent conflicts, has worked well in practice. Any apparent conflict of interest seems relatively simple and transparent. Furthermore, other factors mitigate any risk, much as the consultation notes:

- First, what corporate issuers are buying is the credible information provided by the rating report by the CRA and the easily accessible quick guidance provided by the rating symbol allocated. The credibility of the CRA is fundamental to the transaction.
- Second, a major part of the cost of a rating for a corporate issuer is the management time taken up in securing/maintaining the rating. So the CRA knows that (within reason) its fees for the rating given will not cause a corporate issuer to switch agencies. Bringing a new agency "up to speed" is just too much trouble. Technically, the opportunity cost of the management time simply too high. So, except in maverick cases, there is no real pressure on a CRA to give a "high" rating in order to preserve the income stream.
- Third, the main CRAs commit to rating a company once they have started, so the issuer knows that cancelling the agency contract at the first opportunity will not stop the issuing and updating of an unwanted rating: there would only be the minor satisfaction that eventually the company would stop paying the agency.
- Fourth, in the matter of future issues by the issuer, the above arguments apply – so it is very unlikely that there is any pricing or rating pressure on a CRA to compromise itself in order to receive fees on rating future issues.
- Finally, investors usually require ratings from one or more of a small number of established CRAs and, for this reason, realistically, companies are unlikely to find an easier ride when they turn to another agency.

Also, it is unlikely that the alternative user-pays model would generate sufficient revenues for the credit rating of other than the largest issues. Most issues would not be rated. This would seriously weaken flow of information to investors and make issuance much harder and more expensive for most issuers and this would not be in the public interest. An analogy is seen in the equity markets where analyst coverage of smaller companies is seriously limited. The large US private placement market, with alternative rating procedures is also interesting for comparison. Investors are large/sophisticated enough to develop a relationship with the issuer and make their own credit assessment.

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given default" ratings to complement corporate default ratings illustrates what we have in mind.

[3] Corporate and sovereign securities are inherently different in many characteristics, but this has been well understood over the years and we doubt if, for them, suffixes would add value.
The only other instance where suffixes might be considered is in rating of US municipal and State issuers. The problems of "monoline insurers" have drawn attention to the very low historical default rates for such issuers compared to those of corporates of similar rating. If this phenomenon were considered inherent but not widely understood, it may be argued that some suffix might be appended to distinguish municipal ratings.

Public ratings from the major CRAs are significant among the information sources for investors not in this favoured position.

On the other hand, as each structured financing is (more or less) unique, there is no, or little, saving in management time by sticking with the same CRA after other agencies have rated that type of credit. I.e. there really is a credible risk of potential price and ratings conflicts of interest for CRAs regarding new structured financing ratings. Of course the CRAs have/should have procedures in place to manage the risks arising from this.

Probably the issues associated with the user-pays model, discussed above, would also apply to structured ratings.

We are sure that the main CRAs, aware of the points set out above, seek to have appropriate structures and systems in place to handle them well.

Even so, a strengthened code of conduct regarding the stronger conflicts in respect of structured ratings may also be appropriate – especially if new CRAs are encouraged into the market.

Competition

The absence of the high (opportunity) costs in management time in switching CRAs noted above for corporates makes competition more of a factor in structured markets. Competition has positive aspects but here it increases the importance of the conflicts of interest in the CRA revenue model in structured markets. If there are to be more competitors in structured markets, a strengthened code of conduct may be appropriate.

Level of CRA or other due diligence

CRAs generally rely on the statements made to them by the sponsors of the structured credit in the same way as they rely on statements made to them by corporate or sovereign issuers provided they are not manifestly in error or inconsistent with other information available to the rating agency.

It has not been the role of CRAs to conduct a separate audit/due diligence and we do not believe that it should be. This is not an area where they have the necessary expertise[4].

Historically, the structured-credit SPV issuing the securities and any security trustee would rely on the representation and warranties of the sponsor as regards the attributes of the underlying assets. Breach would trigger a put from the SPV to the sponsor. Proof of breach however could very difficult, but the recourse was there in principle.

Over the years the representations and warranties have been watered down to be less and less meaningful. Purchasers of the securities do not seem to have focused on this. The prospectuses (most issues are listed, although there have been some private placements) are long and little read. More investor due diligence is indicated.

More due diligence by the rating agencies or by accountants or lawyers working for the SPV in respect of the securitised portfolios, e.g. by random testing of the attributes of the underlying assets, for example mortgage loans, forming part of it could address the point. However, this would have a very adverse effect on the timetable for and cost of

[4] It is important to distinguish between the monitoring of reported positions (e.g. in the rating of liquid money market funds – see footnote 1) from auditing the underlying positions.

the proposed issue. In a portfolio of, say, 20,000 mortgages, how many underlying files would have to be looked at carefully? 200? 2,000? This would take weeks and cost a lot.

The absence of such due diligence, however, leaves a securitisation system open to abuse particularly in the face of investor reluctance to read prospectuses and assumption that a credit rating was an indicator of price and liquidity.

We are sure that more requirements on CRAs are not a solution to this.

Comments on specific recommendations

Recommendation 6 (Appropriateness of existing methodologies and models)

We consider that this recommendation is overly restrictive.

We agree, of course, that the CRA should not, potentially misleadingly, force the rating of a novel instrument into an unsuitable established category of rating. However, why should a CRA be constrained from using a new structure or category of rating to accommodate the novel instrument, provided that it makes it clear what it is doing and publishes its methodology, etc. appropriately per recommendation 13 and elsewhere in the code?

Recommendation 7 (Proposals or recommendations by CRAs on structured finance products they rate)

Recommendation 7 is expressed to be relevant to structured ratings.
The key is in the words "making proposals or recommendations" – active consultancy which could make the CRA complicit in the issue of the security.

We support it, but we would like to comment further on Provision 1.14 and the proposed 1.14-1

1.14

We consider (existing) Code provision 1.14 (no commitment to a rating prior to the rating assessment) is important. But the second sentence weakens the impact of the first and is unnecessary.

A "prospective" assessment cannot be "the" assessment referred to in the first sentence. A CRA should *not* be committed to a rating indicated in a prospective assessment for any transaction, even for a structured finance transaction. The CRA should be free to respond to external events, changes in the security or its issuer or with regard to other involved parties such as guarantors, parent companies, etc. or in the CRA's own re-evaluations prior to issuing *any* new rating. For structured ratings, the second sentence undermines this vital principle.

Of course, a CRA must also be free to change an issued rating in response to similar considerations at any time after issue.

1.14-1

We do not consider that a CRA should *as part of its ratings business* "make proposals or recommendations" about the structure of any security or the business underlying it.

We realise that the consultation report is only concerned with structured ratings.

However, were a similar provision to 1.14-1 to be considered in the context of corporate ratings, we think that that would raise some key definitional points.

In rating ordinary corporates, in the course of normal discussion between the company and the ratings analyst, the latter will quite naturally make comments of concern or contentment with aspects of the business or financial structure of the rated firm or aspects of the rated security. This informal education of the issuer is surely a good thing.

The *Code of Standard Practices for Participants in the Credit Rating Process*[5] issued by the ACT and other national treasury associations on the 2003 initiative of the International Group of Treasury Associations includes

> 6.2. The CRA should disclose to the issuer … the key assumptions and fundamental analysis underlying the rating action, as well as any other information that materially influenced the rating action and that could influence future rating actions.

When a corporate issuer is considering a significant change – an acquisition or disposal or significant change to its financial structure, etc. – it may talk informally to the rating analyst about how outlined plans or possible solutions to aspects of them might affect the rating and this will inform its thinking. We regard this as a normal client service and part of the CRAs being open about their methodologies.

If the company plans to go ahead with a change, it will inform the agency in time for to evaluate the change in a revised assessment so that on public announcement the agency is able to make a definitive statement and the market is not left in doubt about the rating of securities and this is part of a normal rating process.

It is vital that none of these activities should be seen as the CRA "making proposals or recommendations" as envisaged in 1.14-1.

If the company wants a full evaluation of the impact of a hypothetical change or range of changes or advice on particular aspects, this would be provided by a ratings advisory business, part of the CRA's group. The ratings advisory business should be kept separate from the CRA to avoid conflicts of interest, and be separately remunerated. The ratings advisory business can of course also be a source of information for the issuer on how the ratings criteria in use by a firm may need adaptation to a particular type of circumstance and this can inform representations from the issuer to the CRA. Some rating advisory activity is also carried out by some investment banks and others particularly in relation to first-time issuers.

Recommendation 14 (Disclosure of possible "ratings shopping")

We wonder if this provision is rather anti-competitive. It seems to make it more difficult for a new or expanding agency to have the opportunity for rating competing with established agencies.

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[5] Issued in April 2004 and March 2005 by the ACT (UK), the Association for Financial Professionals (US) and the Association Française des Trésoriers d'Entreprise (France) on the 2003 initiative of the International Group of Treasury Associations. Available (free) in English at http://www.treasurers.org/purchase/customcf/download.cfm?resid=1937.

The language would not translate directly to corporate (or sovereign) ratings, but any similar provision for these categories would surely discourage un-rated issuers beginning to think about taking a rating.

Recommendation 17 (Symbols)

We discussed the general position of symbols above. In that context, this recommendation 17 seems to be too widely drawn.

First, it is clear already that securities of a corporate, sovereign, money market fund, municipal, etc. will each be likely to respond differently to external factors according to the class of issuer they fall in as well as being subject to their own internal factors. Investors are quite familiar with this point.

Secondly, while the broad idea is the same, then, investors would not and should not expect a designation to be applied in quite the same way (or with quite the same implications) to different categories of instrument. CRAs have explicitly recognised this through a subscript to the rating, particularly in regard to money market funds (AAAm). We have urged, above, that this be extended to a further suffix for structured financings.

We think that Recommendation 17 should be modified to accommodate these points.

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The Association of Corporate Treasurers

The ACT is a body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf

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