The great ratings battle

WITH POLITICIANS EAGER TO HAND OUT A CANING TO SOMEONE FOR THE FINANCIAL CRISIS, CREDIT RATING AGENCIES HAVE COME UNDER ENORMOUS SCRUTINY. **PETER WILLIAMS** REPORTS ON WHAT THE MPS ON THE SELECT COMMITTEE INVESTIGATING THE AGENCIES HAVE BEEN HEARING FROM THE TREASURY PROFESSION.

Politicians are still trying to work out the role that the credit rating agencies played in the financial crisis and how they should be regulated in the future. Whether they resist the urge to cry vengeance remains to be seen. Certainly the MPs on the Treasury Select Committee aggressively questioned rating agency representatives when they appeared before the influential parliamentary committee. A hostile stand-off even developed, with the rating agencies refusing to offer the apology that MPs were demanding for their role in the banking crisis. They reckoned they had nothing to apologise for.

However, the atmosphere was certainly less aggressive when corporate treasurer Malcolm Cooper and the ACT's John Grout appeared before the committee as witnesses. Both gave MPs a fascinating insight into how non-financial corporates use rating agencies and their rating, and how the proposed tougher regulation would affect them.

ISSUER-PAYS VS INVESTOR-PAYS Cooper, global tax and treasury director at National Grid and a former president of the ACT, explained to the committee how the ratings process worked. He revealed that National Grid, which has 15 rated entities in its group, ranging from BBB+ to A2, paid the rating agencies "several millions pounds a year" for their services. He denied the suggestion put forward by MPs that the issuer-pays model created a conflict of interest, saying, "I don't believe you could pay for the rating you wanted," and pointing out that rating agencies had processes to ensure that ratings analyses were performed accurately.

He added that he did not believe the investor-pays model would work because the big investment management firms would decide their own expertise would allow them to dispense with a rating, leaving the cost to fall disproportionately on smaller investors. "Ratings are not just used by investors," Cooper said. "As a corporate I used ratings everyday for various business decisions – for instance, where do I place the company's spare cash?"

He added that the issuer-pays ratings model created a contract between a company and its rating agency setting out the business terms, which included confidentiality. "Under the terms of the confidentiality agreement I am willing to give them [the rating agency] forward-looking information that would never go to an agency I did not pay. So the quality of the information available to the rating agencies would be significantly lower [under the investor-pays model] and, in my view, would make the quality of the end-product significantly inferior."

MPs struggled to understand the relationship between the company and its rating agency. Refusing to supply information or

concealing information which came to light later would, in Cooper's words. "be held against you" by the agency.

Responding to Cooper's explanation of the need for trust between the two parties at the highest level and for belief in the integrity of the information handed over to the agency, committee chair Andrew Tyrie said: "You are not filling me with great confidence." He clearly assumed there must be huge optimism bias in the information passed to rating agencies although Cooper's argument was that part of the agency's role was to assess and deal with that risk.

Cooper said that for National Grid – whose current debt stands at about £25bn – a notch in its ratings is worth 10 to 15 basis points in terms of the cost of borrowing. On hearing this, committee member Jesse Norman said: "So the incentive to get the right rating from an agency, potentially playing them off each other, is enormous in terms of lowering your cost of borrowing." Cooper set him straight: "I don't think it is possible to play agencies off against each other. What you have to do is make sure the rating agency fully understands your business and gives you an accurate rating reflecting your business."

MP Andrea Leadsom noted: "Twenty-five years ago, I was selling synthetic floating rate notes to investors and they were literally buying any old thing so long as it had an interest rate swap with Barclays' name on it and was triple A rated. That is in complete contrast to what you say, that investors do their analysis."

Grout, the ACT's policy and technical director, told the committee that the issuer-pays model offered convenience for those looking to invest large sums of money by providing an opinion on the creditworthiness of institutions or financial instruments which it would be hard to find or replicate elsewhere. He also dismissed fears that rating agencies were influenced by the fees they earned, pointing out the level of income derived from any one client – even one as significant as National Grid – was not a material part of their income.

However, he did concede there was a potential problem with structured credit ratings, which provided rating agencies with a growth opportunity in a slow-growth industry. Grout said: "This growth opportunity was controlled by a handful of banks. The sponsoring bank had enormous influence over that section of the rating agency's revenue. It is very important to distinguish between corporate and structured credit ratings."

PLANNING AN ISSUANCE MPs asked Cooper if the terms of an issue were ever changed to improve a rating. He replied that in vanilla debt issuance that would not happen but that in structured finance the rating could be changed by altering the terms of the bond. "Improving [the rating] can be done by giving it greater security or giving it first right of claim over assets. Alternatively you can subordinate it to other debt and so reduce the rating."

Grout told the committee that ratings were "lagging indicators" and, unless an exceptional event took place, anyone surprised by a change in a credit rating had not been "paying attention". This flag has become even more pronounced since the rating agencies started using outlooks (indicators that a rating switch may be around the corner). He told the committee that the temptation for investors was "just to follow the letter rating rather than read the reports".

One MP, Teresa Pearce, drew a parallel between audit firms and rating agencies, and criticised both industries for lack of competition, dominance of the market by a handful of big players and too cosy a relationship with customers. Grout replied that the company relationship was different for auditors and rating agencies. "The expensive part of credit ratings is the time your senior management, including the treasurer, spends with the rating agencies. If you are told there are now going to be more rating agencies and you have to train up a new rating agency, this is bad news because you have to get face-time with them. That is why there are only three."

On the European proposals for greater regulation, Grout told the committee that the full effect from the first round of changes had not yet been felt. "The effect of some of the provisions in CRA 3 [the latest proposals] is that solicited ratings would disappear." Cooper added that as an issuer National Grid's cost would go up enormously. "Rotation is completely unworkable," he said. "National Grid is a frequent issuer and I would need to change agency every year. You cannot reappoint an agency within four years. So at the end of three years I would have gone through Moody's, S&P and Fitch and would not have a rating agency to go to."

Where treasurers stand

The ACT has aligned itself with the position on credit rating agencies adopted by the European Association of Corporate Treasurers (EACT). The treasury profession is objecting to the proposals from the European Commission on tougher regulation for rating agencies on the grounds that it is likely to adversely affect non-financial companies both as rated debtors and as users of ratings in their business activities.

In a response to proposals sent by the Commission to the European Council and Parliament at the end of February, the EACT said its concerns included:

- proposed mandatory rotation of credit rating agencies;
- proposed oversight by the European Securities and Markets Authority (ESMA) of rating agency methodologies, as opposed to seeing that agencies have followed agreed processes; and
- proposed increased civil liabilities of rating agencies, which seem to confuse them with investment advisers or credit insurers.

The EACT position paper is at **www.treasurers.org/node/7751**

Give me the right rating

John Grout explained to the committee that treasurers don't want a high rating but an accurate rating. He told MPs that when he was director of treasury at Cadbury Schweppes a rating agency that entered the market gave the company an unsolicited rating that was too high – AA – because it was not privy to the company's plans, which included two large acquisitions.

Grout said: "The AA is the rating which we might have been if you only looked at the numbers and did not have that strategic access. I spent a lot of time over the years persuading them to drop us down to A. The population that invests in a company is determined by the risk profile that they think it has. To be downgraded not just by notches but whole rating steps is a significant event for investors."

Peter Williams is editor of The Treasurer
editor@treasurers.org