EUROPEAN ASSOCIATION
OF CORPORATE TREASURERS

The European Association of Corporate Treasurers

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Credit Rating Agencies

Proposal for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies

This briefing note has been prepared by the European Association of Corporate Treasurers[1] (EACT) in response to the European Commission's proposal for a Directive (COM(2011) 746/2) and a Regulation (COM(2011) 747/2), as well as the Draft Report by the European Parliament (2011/0361(COD)) on the regulatory proposals.

Executive Summary

The EACT and treasurers working in companies across Europe have a keen interest in the availability of high quality credit ratings. Our members and their companies use credit ratings to assist in raising new borrowings and also as an information source in their dealings with financial institutions and other businesses generally. With solicited ratings the issuer provides confidential information on business plans and strategy to the credit rating agencies (CRAs). This is assessed by the CRAs and reflected in their rating decisions and in their reports, without disclosure of confidential information. The publication of credit ratings is an important mechanism in the provision of good quality information to the markets.

As with all new financial regulatory proposals it is vital to consider any harmful effects on the real economy. In the case of the new CRA proposals the EACT believes that there could be significant unintended consequences that lower the quality and richness of the information conveyed to the market through ratings. Such a reduction in quality (and reputation) of ratings may lead issuers to cease to value being rated and the EACT considers this will further reduce the flow of good credit information to the markets.

The EACT believes that the ***proposals for mandatory rotation*** of CRAs are both impractical and remove the continuity of experience in the CRAs, as well as the ability of users of ratings to assess the reliability and consistency of ratings over an extended period. A "forced" rotation may bring in a ratings firm without the necessary experience and reputation to prepare sound analysis; in addition, issuers will not want to disclose confidential information to a CRA they have not learnt to trust.

The ***proposal for ESMA oversight of methodologies*** creates the danger that the range of different approaches to credit analysis will be lost, leading to the feared reduction in the quality of market information. The CRAs' different approaches (such as the Moody's combination of probability of default and loss given default into one rating, whereas S&P publishes separate ratings for each aspect) play a part in building financial stability through the data they offer to the users of ratings.

The EACT calls on the European Parliament and Council to take into account the risk of damaging the value and usefulness of credit ratings for end users through the proposals now being considered. The EACT is concerned about the implications of some of the additional issues raised by the draft report of Rapporteur Dominici for the ECON Committee of the Parliament.

[1] Background information on the EACT and contact details are provided on the last page of this note

EACT briefing

The EACT is concerned by the addition of a number of new regulations — both finalised and nearing finalisation — in areas that directly impact treasurers' activities: Basel III for banks, Solvency II for insurers, new regulation on derivatives and CRAs. Insufficient attention has been given to the harmful effects of these regulations on the real economy, particularly in the field of corporate funding.

The EACT underlines to regulators that corporates (the real economy), while they are directly and negatively impacted by the new regulations, were not at the origin of the financial crisis; and in the case of the CRAs, no significant incident has been identified the past years giving legitimate concern about the ratings of corporate issuers.

Treasurers have had a long-standing interest in improving CRAs' operating behaviour. The French, English and American treasurers' associations issued their own Code of Standard Practices for Participants in the Credit Rating Process in March 2005. This work was substantively included in the code principles subsequently published by the International Organisation of Securities Commissions (IOSCO).

Companies make use of credit ratings in a variety of ways:

- to assist in any funding from the bond and loan markets;
- to assess the risks from taking on exposure to financial counterparties through investments, risk management and other transactions;
- to help assess and manage the business risks arising from trading with their customers, suppliers and business partners; and
- in the case of sovereign ratings, to reflect these in the decisions referred to above and as a significant part of strategic planning activities etc.

The process of gaining a solicited credit rating involves the issuer in providing the CRAs with confidential information on business plans and strategy and allows them extensive contact with management. This information is digested by the CRAs and reflected in their ratings levels awarded and in their reports but without disclosing confidential information. It is thus an important mechanism for providing good quality information to the markets. The EACT is concerned that some of the measures in the proposed regulation will threaten the quality of that information flow.

It is against this background that the EACT expresses here its views on the draft amendment to CRA regulation currently before the European Parliament and the Council, focusing only on the more important elements.

The EACT believes that certain measures under consideration are going in the right direction. For example:

- the importance and treatment given to actions on rating "outlooks'';
- the incentive given to market participants to conduct their own analyses, using ratings as one consideration rather than relying solely on the opinions of CRAs;
- the requirement that references to credit ratings be removed from regulations where practical;
- the requirement for two ratings from two CRAs for structured products, thus recognising the real and necessary distinction between the rating of a company and the rating of structured products created and distributed by banks/financial intermediaries;
- the requirement for greater transparency on CRAs' invoicing; and
- the need to clearly identify unsolicited ratings.

However the EACT believes that other measures would have material negative consequences on the rating of corporate issuers:

1) The most questionable element for the EACT is the compulsory rotation of CRAs every three or six years, according to whether the rating is established by one or two CRAs. Such a rule is inappropriate in the context. Furthermore, it fully neglects the necessary commitment that both the issuer and the CRA must make in solicited ratings to ensure proper understanding not only of the issuer (which goes without saying) but also and especially that of the industry, the position of the company in its sector, its internal policies (particularly financial and risk management) and so on. This proposed rotation disregards the value of the necessary continuity in the monitoring of the company and of its business sector.

For investors that continuity is important too so that they, and others, can monitor the track record of the CRA's views over an extended period of time and over the whole life of a long term bond.

The EACT does not believe that this extension of the principle of rotation (which European regulations have already implemented for credit analysts within CRAs) will enhance competition within a sector, because issuers are only willing to pay for ratings that are recognised internationally. If the rotation principle forces the use of a CRA lacking suitable expertise or a recognised reputation, issuers will simply have to decide if the rating has real value or whether they may elect to cease having a solicited rating.

Rotation also ignores the different methodologies used by different CRAs and differences in the ratings. For example, some CRAs publish default ratings and separate recovery-given-default ratings, while others "notch" their default ratings to take account of different recovery probabilities.

Lastly, the proposed principle that a CRA must hand over its files to its successor at the end of its contract encourages a view of rating as a perfectly routine process. This is unfair and can only negatively impact the quality of this same process. CRAs are given highly confidential information. If there is any risk that this information has to be passed on to an unknown replacement CRA issuers will cease to disclose that information in the first place. If this happens then ratings become mere public information ratings and lose much of the forward-looking insight possible now.

2) The EACT is also concerned about the proposed ESMA approval of methodologies used by CRAs. Transparency of rating methodologies is already good. CRA methodologies are widely publicised and are accessible to all market participants; any modification of these methodologies is subject to an open consultation process prior to being implemented.

If rating methodologies have to be approved by ESMA there is a danger that a degree of uniformity of approach will be introduced; this will result in a loss of crucial information to the markets. At the moment the fact that methodologies differ means that each rating brings out different subtleties on the business and credit risks of the issuer. Understanding why different CRAs give different weights to certain characteristics provides a deeper understanding of the issuer's credit.

It is valuable for investors and other market participants that CRAs are able to use the same general methodologies worldwide. Today this is the case. This will cease to be possible if official approval is required for methodologies in Europe. The EACT fears that involving a public regulatory body could diminish the perception of ratings concerning European issuers, on the grounds that they were established using different/regulated methodologies.

3) Imposing civil liability on CRAs is another cause for concern. The EACT understands the need to address cases of glaring and manifest errors in CRAs' compliance with regulations. This is best dealt with administratively. The EACT would oppose expanding the notion of liability, keeping in mind that CRAs are not auditors and neither are they investment advisors nor credit insurers. Imposing an excessive and wide liability would dramatically increase the cost of ratings because of the increased capital requirement (insurance, itself expensive, will probably not be available in sufficient quantity). This increase in cost would discourage issuers from seeking ratings, thus depriving the market of valuable information and opinions.

It is proposed in the draft Regulation that the burden of proof is changed, so that the CRA will have to prove it did not commit any infringements alleged against it. This opens the CRA to potentially vast expense of rebutting frivolous claims, the cost of which will inevitably be borne by issuers in the fees they pay. Reversing the burden of proof is a violation of principle that should only be made in the most difficult cases and with the strongest justifications; we do not see such justification here.

Furthermore, while regulators properly wish to open the sector to competition, the proposed measures on liability would have dramatically the opposite effect, potentially limiting the appetite of possible new entrants.

The EACT calls on regulatory authorities to take into account that fact that solicited corporate ratings, for which the issuer invests time and financial resources, should enjoy uniform quality and perception on all markets. There is considerable risk that excessive or ill-adapted regulation could lead markets to consider the ratings of European issuers with suspicion. Furthermore, as Europe moves towards decreased financial intermediation and greater reliance on capital markets, the imposition of greater requirements on CRAs can only make the rating process more expensive and time consuming, thus preventing smaller companies (including SMEs) from seeking ratings.

Additional comments on Rapporteur Domenici's draft report for ECON

We have seen the draft report of Rapporteur Domenici and we make some additional comments below on four points within the proposed amendments in that draft.

1. Amendments 2 (to Recital 6) and 27 (to Article 6) seek to move to a wholly "investor pays" business model for CRAs. The EACT believes that the investor pays model is likely to result in reduced coverage of companies – especially of sub-investment grade companies and of mid-sized and smaller companies. Such a move may tend to reinforce the dominance of the largest CRAs, limiting the growth of real challengers. Investors would need to subscribe to the incumbents because of their wider coverage. Investors are likely to supplement that only with small, specialist CRAs. Historically the shift to "issuer pays" was in part because of the need for wider coverage, as companies were obliged to turn to debt capital markets with the banks' capacities becoming less adequate.

2. Amendments 3 (for a new Recital 7) and 30 (to Article 6) seek to limit a CRA's market share to 25% of an asset class. Unless a CRA has comprehensive coverage it is more difficult to assess the quality of its ratings. Combined with the proposed rotation, this makes for a very fragmented ability to track the performance of a CRA applying its full methodology. The EACT sees great difficulty with the mechanics of such a limitation – for instance, how rationing of a highly-demanded CRA's services will be determined. But it may have the advantage that in a fragmented rating market the arguments for other regulation of the business to prevent abuses largely drop away, enabling an important simplification of regulation.

3. Amendment 9 (for a new Recital 29) proposes to prevent CRAs from issuing 'Outlooks' for sovereign issuers. The purpose of credit ratings is to reduce, in part, the informational inequalities between issuers and investors and between different investors. While CRAs are relatively slow response indicators, this is mitigated by the publication of "outlooks" ("stable", etc.) and the ability to put issuers on "credit watch" (perhaps with "positive" or "negative" expectations). It is important to remember that ratings are about the necessarily uncertain future – not the possibly better understood past. Any commentary issued by the CRA at the time of changing or affirming outlooks adds further information. The alternative is to force CRAs to change ratings more frequently and possibly unnecessarily. The EACT believes that the combination of effects would be to make markets more volatile. This would also damage corporate issuers, given the relationship between sovereign and corporate ratings.

4**. There is a move to avoid the use of the word "opinion" about credit ratings** (for instance, amendment 18, amending Article 1). Credit ratings are not determinative – they are merely statements of opinion about the future. The EACT believes that anything that encourages users to give too much weight to CRA views by using more positive language should be avoided.

The European Association of Corporate Treasurers

The EACT is a grouping of 20 national associations representing treasury and finance professionals in 19 European countries. We bring together in excess of 8,500 members representing approximately 5,000 companies located in Europe. We comment to the European authorities, national governments, regulators and standard-setters on issues faced by treasury and finance professionals across Europe. We seek to encourage the profession of treasury, corporate finance and risk management, promoting the value of treasury skills through best practice and education.

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