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Dear Dr Muehlbauer

Proposal: Specification of requirements on rating services including rating processes and rating methods

We have become aware of the proposal from DIN for a new ISO covering some elements of the credit rating process. We wish to make representations from the community of corporate treasurers who are users of credit rating services and also are the recipients of credit ratings in respect of various capital markets issues. We thus comment from two ends of the ratings market.

Further information about the Association of Corporate Treasurers and contact details are provided at the end of this letter. This letter is on the record and may be freely circulated, reproduced or quoted from, with acknowledgement.

Background

Treasurers make extensive use of ratings for assessing external credit risks. Treasurers are often responsible for investing the surplus cash of companies and for dealing in the financial markets for all manner of financial instruments that can involve a large credit exposure to banks and financial institutions. They can also be involved in influencing the investment decisions and credit policies of their pension schemes often using credit ratings as a key criterion. They are involved in insurance matters looking at the financial strength and claims paying ability of insurers, where again ratings play a part. They may set policy for customer credit standards and limits. They can also be involved in new business developments abroad where country or sovereign ratings play a role.

Treasurers are responsible for the funding of their organisations and as such are issuers in the capital markets of securities that carry a rating. They will be the company officer responsible for getting and maintaining a rating to support this access to the markets.

Our perspectives are those of the users of corporate credit ratings as used in the wholesale financial markets, rather than ratings of individuals at what might be termed the retail end of the market.

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The proposal

The proposal appears to be seeking to create standards to ensure a minimum degree of professionalism and procedures around the ratings process and in particular you mention:

"Specifying the minimum objectives of rating; delineating the things to be rated; and documenting and describing how a rating comes about. In addition, it must be possible to explain the meaning of a rating symbol and illustrate how a decision was reached, and those responsible for the rating must demonstrate a minimum level of know how or training."

As users of credit ratings we can not see a need for an ISO standard, and indeed would go further and register some disquiet with the whole idea. An attempt at creating 'standards' could even be negative for the market.

- We understand that often an industry will itself seek standardisation where there can be benefits to all e.g. creating standard screw threads benefits all manufacturers by allowing them to have competitive access to all customers, which in turn benefits customers. In this case, there is no evidence that the rating agencies themselves have seen a need to request a standard.

- Like regulation, standardisation is needed only when there is an obvious market failure or overwhelming benefit to be grasped.[1] That is not the case here.

- The area of professional care, ethical behaviours, independence and conflicts etc have all been covered by the IOSCO Code and the various codes of conduct individual agencies have adopted.

- The EU, CESR and IOSCO have all investigated the Credit Rating Agencies (CRAs) and not found the need for regulation.

- Standardisation is of more use where there is a large and disparate industry where creating norms simplifies matters, e.g. screw threads. In the case of CRAs operating at the wholesale markets level there are not many of them so users can relatively easily get to understand all the players, their objectives, their rating reports and their service quality without the need for an external set of specifications.

- Many of the users of credit ratings are likely to be well qualified investors or regulators whom we expect to have the resources to establish for themselves the level of confidence they have in any CRA.

- The list of areas to be standardised covers areas where the agencies are very transparent so that standardisation seems rather pointless.

Credit ratings are ultimately an opinion, albeit founded on extensive analysis. We welcome your comments that there is to be no attempt to dictate a standard form of analysis. Users appreciate that the CRAs will have slightly differing approaches and it is these differences that add colour and insight to the end result. CRAs can only survive in the market if they maintain a reputation for integrity and sufficient skills in their work so that the end result – their track record – is of good quality. To an extent the market is self regulating in that only those CRAs with adequate standards will survive.

An ISO for credit ratings could introduce a barrier to new entrants to the market and harm competition. A new entrant may have a unique new viewpoint or methodology and to make its mark it might want to distinguish itself from the established CRAs by using a totally different rating symbol and scale. Dun and Bradstreet for instance use a scale from 1 to100 which ranks where a business stands among all

[1] The ACT technical manifesto which includes the agreed position the position the ACT takes on regulations says: "Regulation commonly represents a barrier to entry, restricts competition and innovation and increases costs. It should thus normally only be used as a last resort where there is evidence of an actual or potential market failure or in quasi-monopoly areas where competition is insufficient, industry codes etc. have failed and where the public good from regulation manifestly exceeds the costs it engenders.

Where regulation is to be applied it should be with a bias towards light-touch- and principles-based regulation to lower costs and preserve as much flexibility as possible."

See http://www.treasurers.org/technical/resources/manifestosept2006.pdf the scored businesses in the database. A score of 85 means that 84% of the database has a higher level of risk of failure. This is very different from the letter based scale used by Moody's and Standard and Poor's, but there is no harm in having both co-exist. The different scales convey different information, but this is an advantage not a problem.

Secondary points of detail

There are a few minor details in the proposal which warrant an individual comment.

"*Rating has become an obligatory part of the process of obtaining credit."* This is not strictly true. It can be very important for regulated banks or insurance companies but many corporates take the view they can access the capital markets without a formal rating. Furthermore when accessing the bank lending market a company does not need a rating. The banks do their own credit evaluation.

"The discussion on the regulation of ECAIs in a similar vein to banks and insurance companies has not yet come to a close." To an extent this is true in that discussion never ends, but for the moment the European Commission and IOSCO have both concluded that regulation is not required.

"Rating in the sense of this standard is the assessment of debtor solvency." A credit rating can convey an opinion on various aspects of credit standing. The principle elements covered by a rating are the probability of default and the loss given a default, but there are other nuances. For example immediate liquidity is important for a Money Market Fund rating. Implied state support is important for a major national bank. Solvency in the sense of an excess of assets over liabilities is not always the most important factor. An asset rich business which is solvent but without access to immediate cash resources will not be able to pay its creditors in a timely manner.

Conclusion

We fail to see the need to create a standard in an area where there are no real benefits to be gained, but where there could be additional cost implications.

Yours sincerely

Martin O'Donovan

Assistant Director – Policy and Technical

The Association of Corporate Treasurers

The ACT is the international 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, financial institutions and professional service firms.

Our guidelines on policy and technical matters are available at http://www.treasurers.org/technical/resources/manifestosept2006.pdf.

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