

REDEFINING THE CREDIT RATING ROLE

RATING AGENCIES HAVE ONCE AGAIN HIT THE HEADLINES IN THE US. **JOHN GROUT** OF THE ACT PREVIEWS A FORTHCOMING REVIEW BY THE US SECURITIES & EXCHANGE COMMISSION AND LAUNCHES A NEW ACT WORKING GROUP.

At the end of January, the Securities & Exchange Commission (SEC) released a preliminary report on the role and functions of the ratings agencies in the US capital markets. The report¹ was prepared in response to Congress's concerns about the part rating agencies may have played in the corporate governance failures at Enron and other companies. The SEC was required to prepare the report under the Sarbanes-Oxley Act 2002.

Before the end of March, the SEC will issue a concept release or consultation document about its future approach to regulation of credit rating agencies. After evaluating comments received, it will then issue new rules on rating agency activity. Any move by the SEC to restrict or alter the function of rating agencies in the US will affect treasurers worldwide. This is because, although credit ratings originated in the US and this is where the three top agencies are based, ratings are now widely regarded as of critical importance to major companies round the world.

THE IMPACT OF THE ENRON CRISIS. Rating agencies are not formally a part of corporate governance. They offer a service, purely at the invitation of their client companies, to provide a relatively independent assessment of a company's credit. However, in practice, the rating agencies have privileged access to top management and other confidential information sources. Indeed, the SEC's rules on selective disclosure of material information about companies² (Regulation FD) provide an exemption for the rating agencies³. The FSA acknowledges similar practice in the UK. By virtue of this access and independence, rating agency opinions attract the attention of current and potential investors. They are, therefore, in reality, part of the corporate governance process.

Despite this 'insider' position, the rating agencies do not always identify problems quickly enough. For example, in the Enron case, they do not seem to have understood any more of what was happening at Enron than other outsiders. Indeed, there is evidence that they were less than diligent in questioning Enron: "In short, based on the credit rating agency analysts' testimony at the 20 March hearing⁴, and what they told Committee staff in interviews, the Committee staff has concluded that the credit rating agencies'

approach to Enron fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness for the purposes of federal and state standards. It is difficult not to wonder whether lack of accountability – the agencies' practical immunity to lawsuits and non-existent regulatory oversight – is a major problem."⁵

BOX 1

Criteria for organisations achieving NRSRO status⁹

- Organisational structure.
- Financial resources (regarding the ability to operate independently of economic pressures or control from the companies it rates).
- Size and quality of the staff (regarding the ability to thoroughly and competently evaluate an issuer's credit).
- Independence from the companies rated.
- Rating procedures (regarding the design to produce credible and accurate ratings).
- Internal procedures to prevent the misuse of non-public information (and whether those procedures are followed).

The SEC also recommends that the organisation register as an investment adviser.

BOX 2

Issues the SEC will study in more depth¹⁰

Information flow

- Whether rating agencies should disclose more information about their ratings decisions.
- Whether there should be improvements to the extent and quality of disclosure by issuers (including disclosures relating to ratings triggers).

Potential conflicts of interest

- Whether rating agencies should implement procedures to manage potential conflicts of interest that arise when issuers pay for ratings.
- Whether agencies should prohibit (or severely restrict) direct contacts between rating analysts and subscribers to the ratings service.
- Whether rating agencies should implement procedures to manage potential conflicts of interest that arise when rating agencies develop ancillary fee based business.

Ongoing oversight

- Whether more direct, ongoing oversight of rating agencies is warranted and, if so, the appropriate means for doing so.
- Whether rating agencies should incorporate general standards of diligence in performing their rating analysis, and with respect to the training and qualifications of credit rating analysts.

Enron's internal investigation into one element of its problems, certain structured finance transactions⁶, "found a systematic and pervasive attempt by Enron's management to misrepresent the company's financial condition." For the rating agencies: "In retrospect ... it was evident ... that Enron, in fact, provided misleading information and failed to disclose other important facts...". Could, then, the agencies be doing more to protect investors?

THE DEVELOPMENT OF RATINGS PRACTICE. Credit ratings have been published in the US for many years. In the 1970s, regulators in the US began to use the published ratings in calculating capital requirements for regulated bodies or restricting the investments of various fiduciaries, insurance companies and the like. In 1975, the SEC began to use them, recognising ratings by 'Nationally Recognized Statistical Rating Organizations'⁸ (NRSROs). The practice spread rapidly. Non-regulated investors also use ratings as information, of course, and they can be used in private contracts, for example, to trigger events in loan agreements.

Today, the SEC applies six main criteria in giving an agency recognised status (see *Box 1*) – apart from noting its pre-existing national recognition (by the users of ratings) in the US.

It gives the status in a back-handed sort of way – issuing a 'no-action' letter saying it will not take enforcement action against a registered broker-dealer if it regards ratings from the agency as being from an NRSRO.

There were three NRSROs in 1975 – Standard & Poors' (S&P), Moody's and Fitch – and while there have been more in the interim, mergers mean there are again just these three today.

At several times, consideration has been given to more formalisation of the recognition process and for more oversight of agencies once recognised, but these have not been adopted.

THE CURRENT REVIEW. The SEC will now consider a number of issues and, before the end of March, issue a new framework for monitoring rating agencies.

What do treasurers really think of rating agencies?

Thought-provoking or merely controversial?

You decide. Do you have strong opinions on ratings practice? Would you like to hear more about the issues and discuss them with your fellow treasurers? Do you need advice on negotiating the ratings world?

If so, why not attend the ACT Conference 'Rating Agencies: Prophets, Judges or Mere Mortals?'. The event, sponsored by Merrill Lynch, will be held on Thursday, 20 March 2003 at the Royal Society of Arts in London WC2. For details of how to register, contact mrahman@treasurers.co.uk.

"Rating agencies are completely unregulated. Given the impact the can have on liquidity, this is increasingly unacceptable."

"Rating agencies and the way they operate are very good for the market."

"Ratings are paid for by borrowers, but the borrowers have no influence on the level of service they receive."

"For a bond review fee of about \$30K you can't expect too much."

"The best analysts do not stay at rating agencies. They usually leave to join banks which pay more."

"Our rating opened up a whole new investor base to us."

It will look at the competitive position of the NRSROs and barriers to entry to the trade of providing ratings services. While companies have often cursed the lack of alternative agencies, in practice, they have felt unable to replace ratings from the existing incumbents with ratings from a new agency – so doing business with the new agency merely represents additional cost: not a long-term prospect.

So the major interest of companies in the review is in the practice of ratings. They will also be asking who might foot the bill for more detailed ratings processes. *Box 2* sets out the principal topics relevant to treasurers in the SEC study.

IMPLICATIONS FOR TREASURERS. Although the SEC's main concerns are naturally with the US market, they do recognise the international implications of rating agency practice, and, of course, the agencies will want to adopt similar practices wherever they operate.

In view of the importance of credit ratings to companies round the world, the Association of Corporate Treasurers (ACT) is establishing a Working Group to study the concept paper now awaited and make any appropriate comments to the SEC. We will also consider whether any representations should be made to the authorities in the UK and Europe about the position of credit rating agencies operating in relation to those markets.

The ACT Working Group will then continue as and when appropriate to provide a forum for treasurers to express their views on ratings issues. Developments now in the rating agency field will be with companies for many years and we must not let slip the opportunity to influence any new rules or practice.

If you are interested in expressing a view on the SEC review or in participating in the Working Group, please contact the ACT at technical@treasurers.co.uk. A link to the SEC paper will be available at www.treasurers.org as soon as it is published.

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Notes

¹ "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, as required by S. 702(b) of the Sarbanes-Oxley Act of 2002", US Securities & Exchange Commission, January 2003 (SEC Interim Report).

² "Selective Disclosure and Insider Trading", Release No. 24-43154 (15 August 2000), 65 FR 51716 (August 24, 2000).

³ The SEC Interim Report explains in note 60 p22, that with the "widely available publication of the rating... the impact of non-public information of the creditworthiness of an issuer is publicly disseminated, without disclosing the non-public information itself."

⁴ "Rating the Raters: Enron and the Credit Rating Agencies, Hearings Before the Senate Committee on Governmental Affairs", 107th Congress 471 (20 March 2002).

⁵ Staff to the United States Senate Committee on Governmental Affairs, "Financial Oversight of Enron: The SEC and Private Sector Watchdogs", 8 October 2002, p 116.

⁶ Powers, William C., Dean of the University of Texas Law School and Chairman of the Special Investigative Committee Of the Board of Directors of Enron Corporation, Testimony before the Committee on Commerce, Science and Transportation, United States Senate, 12 February 2002.

⁷ SEC Interim Report (Note 1 above), p16, summarising testimony of Managing Directors of Standard & Poors' and Moody's and a Senior Director of the Global Power Group of Fitch before the Enron Hearings (see Note 4).

⁸ "Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers", Release No 34-11497 (26 June 1975), 40 FR 29795 (16 July 1975).

⁹ SEC Interim Report (note 1 above), pages 9 and 10.

¹⁰ SEC Interim Report (note 1 above), pages 1 and 2.