Jan Pethick of Merrill Lynch introduces the Ratings Agencies Panel, chaired by John Hawkins of Invensys, left.

SHOW AND TELL

TREASURERS AND INVESTORS ALIKE CALL FOR INCREASED TRANSPARENCY IN THE CORPORATE RATINGS PROCESS. **SHEELAGH KILLEN** REVIEWS THE KEY THEMES EMERGING FROM THE RECENT ACT RATINGS CONFERENCE.

For many treasurers, it seems, a corporate credit rating is much like Forrest Gump's now proverbial box of chocolates – "you never know what you're going to get". It is therefore not surprising that the need for an enhanced information flow on the bases for rating decisions emerged as a recurring ***leitmotif*** in a series of roundtables featuring treasurers, investors and market professionals at the ACT conference, *Rating Agencies: Prophets, Judges or Mere Mortals?*, sponsored by Merrill Lynch.

TRANSPARENCY OF RATING DECISIONS

THROUGH A GLASS DARKLY. "The ratings process can't be a black box", observed David Swann, Group Treasurer at BAT and these sentiments were echoed by Ron Huggett, who manages capital markets issuance for The Royal Bank of Scotland. "My wish is to see a lot more information being given about these ratings and how they are arrived at", said Huggett. John Westby of Aviva also raised the issue that, whilst there was a core of quantitative analysis in the ratings process, appraisals of management, franchises and the like meant that "key components of the rating are subjective". Hence ongoing, supplementary explanations are of vital importance to the treasurer.

David Swann elaborated on his concerns about transparency, citing the dilemma faced by many treasurers in communicating to their Board the reasons for ratings decisions taken by the agencies. "The rating process, the outlook process is too opaque", he contended. His views were echoed by those of David Blackwood of ICI. "Whilst we are generally pleased with the ratings analysts we use," he said, "they often struggle to articulate a framework to treasurers which we can take back to management." There were also issues for treasurers in ensuring that corporate activity did not endanger a target rating. Many used the approach of almost second-guessing key financial ratios driving the current rating assessment. These could then be incorporated into periodic management reporting. However, several treasurers felt that this approach was too "simplistic" and left them exposed, particular in relation to issues such as pensions on which methodology was, as yet, it appeared, somewhat fluid. Treasurers were then left trying to manage a "moving feast" (see p12 for latest from Fitch).

WYSIWYG. Concerns on transparency were also raised by fixed income investors who expressed a market demand for more detailed explanations of factors driving credit ratings decisions. Paul Shuttleworth, a fixed income investment manager at Merrill Lynch,

Panel participants

Treasurers

- David Blackwood, Group Treasurer, ICI
- Tom Fallon, Treasurer, United Utilities
- John Hawkins, Group Treasurer, Invensys
- Ron Huggett, Capital Raising Director, Royal Bank of Scotland
- Andy Longden, Group Treasurer, BT
- David Swann, Group Treasurer, BAT
- John Westby, Group Treasurer, Aviva Group

Market and regulatory professionals

- Francis Burkitt, Director, Cazenove
- Marc Ellegaard, Vice President, Merrill Lynch
- William Mendenhall, Director, Merrill Lynch
- Martin Mills, Managing Director, Merrill Lynch
- Oliver Page, Director, Major Financial Groups Division, FSA
- Paul Shuttleworth, Director – Fixed Income, Merrill Lynch Investment Managers
- Joanne Smetham, Senior Credit Analyst, Fidelity Investments
- Duncan Warwick-Champion, Executive Director, UBS Warburg
- Stephen Wilson-Smith, Head of Credit Research, M&G Investment Management
- Theo Zemek, Head of Fixed Income, New Star Investment Managers

Rating agency representatives

- Hugh Baxter, Vice President and Head of Origination, Standard & Poor's
- Stuart Lawton, Managing Director, European Corporates, Moody's
- Trevor Pitman, Group Managing Director, Fitch Ratings
- Michael Wilkins, Managing Director – Infrastructure Finance Ratings, Standard & Poor's

Main areas where agencies will need to meet standards for recognition

- Objectivity
- Independence
- International access
- Transparency
- Disclosure
- Resources
- Credibility

was looking for "better disclosure, better explanation of methodology across the economic cycle", whilst Stephen Wilson-Smith, Head of Credit Research at M&G, would appreciate "more colour on the rating and more of an idea of how it would change if an important driver of the rating were to change." Both felt that a predictability and consistency in ratings decisions would boost investor confidence. Wilson-Smith pointed out that, amongst the staff employed by agencies, there are "very few people whose job it is to ensure consistency across ratings, across industries, across sectors and across different types of asset." This could result in a mis-pricing of risk which was "neither efficient nor good". Shuttleworth expressed his belief that a lack of transparency in ratings was one factor in the potential occurrence of a market "disconnect between credit fundamentals and credit price behaviour".

CLEAR CHANNELS. Representatives of the three major credit rating agencies were on hand to set out the actions which they are currently taking to improve the transparency of the ratings process. Trevor Pitman of Fitch maintained that it was the stated intention of his agency to "make our judgements as transparent as possible." Michael Wilkins at Standard & Poor's (S&P) noted that his agency had been proactive "in publishing all our criteria, all our methodology" and Stuart Lawton of Moody's also confirmed that his firm attributed significant importance to the transparency of their credit opinions. Amongst the three agencies, there was, however, the proviso that "excessive dialogue" should not be permitted to compromise independence.

In looking at practical ways of how transparency might be increased, Marc Ellegaard, a ratings consultant, commented that, in his experience, the process of communication between issuer and rating agency which existed when an agency provided 'ratings advisory services' (for example, opining on the likely effect on a company's rating of a particular transaction or restructuring) was often superior to that which was employed in arriving at an overall corporate rating. He described the ratings advisory process as having "more transparency, more feedback in terms of expectations" and suggested that to duplicate this approach in the context of corporate ratings would be a "big plus".

Duncan Warwick-Champion of UBS urged treasurers to take a proactive approach to the problem. He encouraged corporates to "sit down with your ratings analyst, push them" and also reminded treasurers that analysts work for issuers as their clients and should be prepared to explain their decisions in some detail. "Make the analyst responsible for his decision", he advised. In conducting this dialogue, ratings consultant William Mendenhall brought out the value of ensuring that an effective language of communication was established. He admitted that, "ninety per cent of my job is to translate what agencies are saying to companies into plain English, and vice versa".

REGULATION STYLE. Oliver Page of the Financial Services Authority (FSA), speaking in a personal capacity, said that increased transparency in ratings decisions could only benefit the financial system by ensuring that credit risks are properly assessed and efficiently priced across the debt capital markets. Accordingly, Page, who works in the FSA's Major Financial Institutions Groups Division, explained that improvements in users' ability to understand the basis of these widely-disseminated credit 'opinions' should be a key objective in the ratings field. The FSA also has an interest in increasing transparency from the corporate side, encouraging, for example, enhanced disclosure of ratings-based triggers.

REGULATION OF RATING AGENCIES

Yet, as Page explained, against the background of the US Securities and Exchange Commission's present enquiry into regulation of rating agencies in the US markets, the FSA does not, at the present time, see a 'rules-based' system of regulation for rating agencies as a means to achieve greater transparency, or indeed its other ratings-related objectives. He noted that in the context of implementing the new Basel Capital Accord, the FSA and other regulators would, however, be consulting on the requirements for rating agencies to be recognised by the regulators. The draft of the new Accord already sets out the main areas in which minimum standards will need to be met by those seeking such recognition (see box, left), of which transparency is one.

CONDUCT OF BUSINESS. The view that an overly prescriptive regulatory framework was not the way forward for ratings attracted broad support at the conference. Weight of opinion instead seemed to support a published code of conduct which would guide and disclose the practices and procedures of the rating agencies. One

"Ratings analysts... struggle to articulate a framework which we can take back to management," David Blackwood, ICI, above.

Treasurers united, left to right: Andy Longden, BT; Tom Fallon, United Utilities; David Blackwood, ICI; and David Swann, BAT, discuss the Issuers' viewpoints

treasurer expressed the view that he hoped this code of conduct would eliminate some of the practices which he saw as being damaging to the industry. Another queried the alleged practice of disclosing ratings fee related details to analysts, a claim which the agencies were quick to deny.

Whilst recognising the potential value of a code of conduct, Oliver Page pointed out that care would have to be taken to balance the value of restrictive requirements against the impact they would have on excluding potential new entrants from the market. This was a contention supported by Francis Burkitt of Cazenove who maintained that "regulators need to encourage more diversity and avoid things which strike it down." Burkitt went on to express his view that the present players in the market already had "similar systems, similar methodologies" and that any code of conduct "should not be so prescriptive that it keeps the existing duopoly or triopoly". He also put forward the idea that bank credit teams could, in the future, seek recognition for ratings services, provided that any conflicts of interest with origination and trading businesses could be appropriately managed. If this model was effective in equity analysis, there seemed no reason why it could not be made to work for debt.

COMMON SENSE. The rating agencies seemed broadly satisfied that a code of conduct could present a workable solution to those concerned about the absence of a formal regulatory framework for ratings. Stuart Lawton described a proposed code as a "sensible way forward" whilst Trevor Pitman saw it as a "sensible idea". Michael Wilkins confirmed that "a code of conduct would not cause any particular problems" for S&P as they have "nothing to hide, nothing to shy away from." However, Stuart Lawton did explain that the contents of the code should not include unnecessary powers of oversight by the regulator or other bodies. "We should be uncomfortable with anything that might compromise our independence or integrity", he said. He also added that Moody's would look unfavourably on any code which served to force harmonisation of methodologies across the agencies as Moody's recognised "the value in diversity of opinion". Trevor Pitman seconded this view on behalf of Fitch, claiming "the more opinions in the market, the better."

HE WHO PAYS THE PIPER. The panel members representing investors did not see regulation of ratings as a particularly key issue for investors, although one fund manager did express "grave doubts about how the rating agencies are funded". Whilst the issue of funding ratings was generally agreed as sub-optimal by both treasurers and investors, no universally acceptable alternative could be proposed. Fund managers questioned whether investors were prepared to "foot the bill" as it is issuers who have the keenest interest in bond issues getting away. For example, the suggestion for a levy on primary issuance used to bankroll independent ratings met with a mixed response as doubts were expressed about both whether a new ratings operator could establish credibility and whether markets would stand additional transaction costs.

Stuart Lawton also defended rating agencies against any claim that the structure of their fee income (which is about 85% derived from issuers) could potentially undermine an objective and dispassionate ratings determination. "No one issuer represents more than one and one half percent of our fee income and the vast majority pay less than one quarter of one percent of our fee income. It would be inconceivable for us to risk our reputation for independence in order to retain the business of any client on that basis."

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The Association of Corporate Treasurers would like to thank all the participants for their kind co-operation in the preparation of this feature. The second part of this article, which will deal with roundtable comments on the role of ratings in the markets, rating agency customer service and tips for treasurers in managing their rating will appear in the next edition of The Treasurer.