

AN AGREED CODE OF PRACTICE



THE PAST PERFORMANCE OF CREDIT RATING AGENCIES HAS LEFT A LOT TO BE DESIRED, BUT MORE REGULATION IS NOT THE ANSWER, SAYS MARTIN O'DONOVAN OF THE ACT.

During the past two years, credit rating agencies (CRAs) have been the subject of much criticism. They have come under fire for failing to warn investors of the collapse of industry giants such as Parmalat, Enron, WorldCom and other companies that later declared bankruptcy or financial restructuring. These events have led some to question whether the CRAs are meeting the needs of market participants. Last month, the Association of Corporate Treasurers (ACT) and its US and French equivalents published an exposure draft putting forward a Code of Standard Practices for Participants in the Credit Rating Process. The code outlines the need for a minimal amount of regulation of CRAs and relies instead on market-based, industry agreed practices. The exposure draft was issued to solicit comment from the widest number of those involved with credit ratings as issuers or as users or providers of credit ratings, and regulators of relevant markets and financial systems, as well as others with an interest in the issue and use of credit ratings.

WORKING TOWARDS A COMMON GOAL. The decision to work towards an industry agreed code was taken at a meeting in autumn 2003 of the International Grouping of Treasury Associations (IGTA). This, in turn, developed from an earlier survey by the the Association of Finance Professionals (AFP) in the US, from the ACT's response to a Securities and Exchange Commission (SEC) concept release, the statement of principles from the International Organisation of Securities Commissions (Iosco) and a best practices guide from the French Association Francaise des Tresoriers D'Enterprises (AFTE).

These treasury and finance professionals rely on the agencies when their companies issue debt and when they make investment decisions. Their relationship with the CRAs provides them with an opportunity to form opinions on both the strengths and weaknesses of the agencies' practices.

The agencies play an important role in the efficient operation of global capital markets. Investors and lenders rely on them to provide an opinion of the creditworthiness of debt issuers and borrowers. Companies also use the ratings to evaluate trading partners, financial counterparties and potential business partners. Debt issuers, which typically pay to have their company and its debt issues rated, expect CRAs to issue ratings that accurately

reflect the company's relative creditworthiness. In many jurisdictions, regulators also rely on the agencies for determining regulatory capital requirements and permitted investments.

In addition, some have asserted that regulators should take a bigger role in regulating existing CRAs and should remove barriers to entry for new ones. These barriers to entry are believed to have contributed to an oligopoly for a few major CRAs and perhaps reduced the need for CRAs to improve their methodologies and stifled innovation.

The associations – the ACT, AFP, and the AFTE, with the support of the International Group of Treasury Associations (IGTA) and Euro Association of Corporate Treasurers (EACT) – have developed the Code of Standard Practices for Participants in the Credit Rating Process to improve investor and issuer confidence in the CRAs. In jurisdictions where CRAs are regulated, the code is intended to complement, rather than substitute, such regulation. It includes three sections:

- regulatory recommendations;
- rating agency code of standard practices; and
- issuer code of standard practices.

LIGHT REGULATION. The regulatory recommendations for jurisdictions where CRAs are regulated are intended to establish only a minimum fail-safe framework for CRA regulation. The recommendations include:

- Establishing or clarifying the criteria and process by which a CRA may attain regulatory approval.
- Approving CRAs based on whether they can consistently produce credible and reliable ratings, although regulators should not prescribe methodologies that CRAs may use.
- Requiring approved CRAs to document internal controls that protect against conflicts of interest and anti-competitive or abusive practices.
- Periodically reviewing approved CRAs to ensure they continue to meet the recognition criteria.

Beyond these basic requirements, the code puts forward market-based solutions that attempt to reduce regulation and avoid fragmentation arising from differences in national and regional regulatory regimes.

ISSUER RESPONSIBILITIES. Recognising the credibility and reliability of credit ratings is heavily dependent on issuers providing accurate and adequate information. The code outlines issuer obligations to the CRAs when they have solicited a rating. These include:

Agency obligations

The **Rating Agency Code of Standard Practices** recommends steps that the credit rating agencies (CRAs) should take to enhance issuer and investor confidence in the ratings they promulgate.

CRAs should take steps to enhance the transparency of the rating process:

- they should publish and adhere to their methodologies and are encouraged to publish the definition and historical default rates of each rating symbol they use.

Confidential information gathered by CRAs during the development of ratings must be protected and not otherwise be publicly disseminated:

- the associations recommend that each CRA documents the systems and policies it has in place to protect non-public information;
- CRAs should not have relationships with related businesses or journalists; and
- CRAs should require all agency staff to sign a non-disclosure agreement.

CRAs must establish and document policies and procedures to protect against potential conflicts of interest by:

- avoiding conflicts that may arise based on ownership structure; and
- having strong firewalls between rating analysts and those responsible for providing rating advisory services.

CRAs must clearly distinguish between solicited and unsolicited ratings, and disclose when a rating was last updated:

- they should disclose how a rating was developed and when the rating was last updated;
- distinguish between solicited and unsolicited ratings; and
- market participants should also be given information about whether the rating was based on statistical analysis, qualitative analysis and/or discussions with the issuer.

CRAs should improve communication with issuers and the market:

- it is recommended that CRAs give issuers an opportunity to review the text of a rating action to prevent the inadvertent disclosure of non-public information and to ensure the accuracy of reported information;
- CRAs should allow issuers to provide feedback to the analyst and rating committee on key assumptions and fundamental analysis; and
- to minimise the impact of rating actions on issuers' financial operations, CRAs should also commit to working with issuers to co-ordinate rating actions with the latter's intentions to access the capital markets.

- An obligation to disclose the issuer's business strategy, the legal and management structure of the issuer and its parent or subsidiary companies, and its management processes.
- An issuer must also discuss the risks and opportunities of its business environment. It should help CRAs understand its approach to risk management and financing, and provide information on its financial policies.
- An issuer should also be expected to provide any other financial information that would allow the CRAs to better understand the issuer's circumstances.

An issuer should inform CRAs about changes in the financial situation of the company. The agencies should also be made aware of any corporate finance actions such as debt issuances or stock offerings that could impact ratings to enable the CRAs to issue or update their ratings in a timely manner. Notwithstanding the requirement to disclose information in a timely manner, issuers should also commit to holding a full review with CRAs at least annually to explain past performance and future prospects, and to provide CRAs with access to the appropriate level of management.

Issuers must also commit to responding to communications from CRAs in a timely manner. They also have a responsibility to react as quickly as possible to information submitted for their review prior to public release to ensure investors have access to timely information and to minimise the possibility of information leaks. During this review period, issuers must commit not to take any actions to pre-empt or counter the release of the rating action to the market.

Issuers should also refrain from issuing any securities, other than to refinance maturing short-term debt, prior to the public release of the rating action being reviewed.

The associations believe that the proposed Code of Standard Practices, coupled with a minimum regulatory framework, is the most efficient and flexible solution to restoring confidence in CRAs and the information they provide to global capital markets.

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The associations look forward to receiving comments and suggestions on the concept of a code for participants and the current exposure draft, as well as to discussions that may arise out of the comments received. The full document may be found on the ACT's website at www.treasurers.org. Readers are invited to send in their comments and views to ratingcode@treasurers.co.uk.