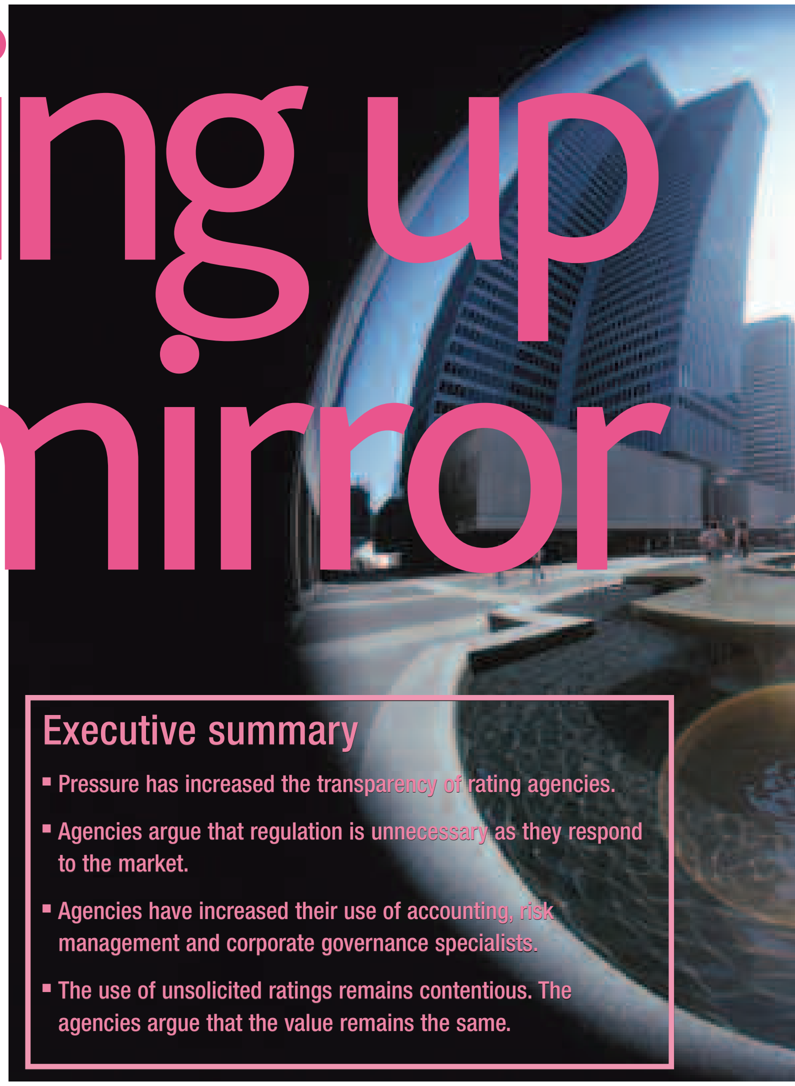
Holding up a mirror



Executive summary

- Pressure has increased the transparency of rating agencies.
- Agencies argue that regulation is unnecessary as they respond to the market.
- Agencies have increased their use of accounting, risk management and corporate governance specialists.
- The use of unsolicited ratings remains contentious. The agencies argue that the value remains the same.

The financial world has been subjected to increased regulation with the likes of Sarbanes-Oxley and international financial reporting standards (IFRS) overhauling the way in which the treasury department works. But, despite the scandals of Enron, WorldCom and Parmalat, the rating agencies have been relatively unscathed by the regulators' firm grip.

After extensive research and discussions among regulators and various bodies such as the ACT, rating agencies now have the Code of Conduct Fundamentals for Credit Rating Agencies from the International Organisation of Securities Commissions. Many argue that this code of conduct has encouraged the likes of Moody's, Fitch and Standard & Poor's to be more transparent about their methodologies and to revise their own internal set of rules.

"It is quite hard to say whether or not the agencies need a lot more regulation or not," says David Blackwood, Group Treasurer at ICI. "The worry must be that with more regulation we would end up too rules-based. However, with none at all, they are potentially a law unto themselves. I think the work done by the ACT in this area has been very good and there is no doubt that rating transparency has improved in recent times."

The Enron scandal put the spotlight on rating agencies, resulting in extreme scrutiny and plenty of speculation about why Enron was not downgraded sooner before its affairs hit the headlines in 2002.

Richard Hunter, Managing Director of Fitch, says: "It is good that Enron created a debate and it has been wide and intelligent. We have adopted a code of conduct which is almost exactly the same as IOSCO [International Organization of Securities Commissions] and we are very happy with it. I think it is fair to say that there weren't major changes for any of the three agencies to conform to IOSCO's code."

Frederic Drevon, Senior Managing Director at Moody's, says that regulation is unnecessary. He argues that the agencies listen to the market and have proved themselves over the years to be reputable and accurate in their methodologies. "If ratings are useful, as we believe that they are, and many investors do rely on them, it is important to understand the reasons for this belief," he says. "The reasons do not relate to regulation but to the fact that ratings have demonstrated predictive power over time and investors trust the opinions."

Drevon says this trust would change if ratings stopped being timely, accurate and predictive of credit risk. "If these things change, the acceptance of ratings is going to change," he says. "If we get this wrong, then the market will react immediately and before regulators would react."

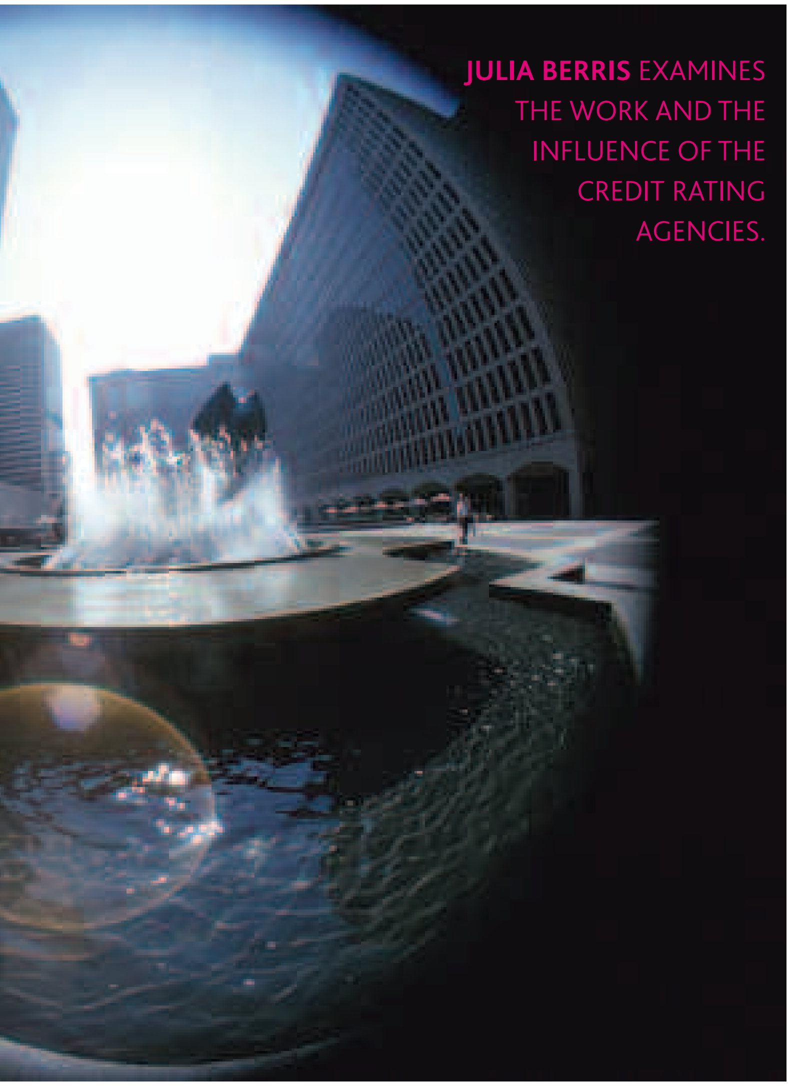
Rating agencies are keen to impress upon investors and issuers that they are not able to detect fraud and it is not their job to do so. Drevon says that agencies should not be mistaken as having this kind of power. "If a management team is dedicated to committing fraud, it is very hard for a rating agency to detect," he says. "We don't have subpoena power and we don't go in with a team of auditors to review books and records. As a result of Enron, the entire market has gone back and focused on what could improve analysis of fraud."

Drevon says Moody's has responded to this renewed focus by increasing transparency and adapting the rating process to be more in line with contemporary attitudes.

"It is difficult for an analyst to be an expert on every topic and every industry," he says. "To support our analysts we've brought in accounting specialists to assist with complex financial statements, as well as risk management specialists to help our analysts understand very complex derivatives and other off-balance sheet exposures. We have also brought in corporate governance experts to help us understand where and how that might add to credit risk. All of this is done to improve the depth of our credit process."

Developing and maintaining good relationships with rating agencies is important for treasurers. There is an inherent tension between issuers and vendors stemming from the concern of being downgraded unfairly.

Ensuring there is good communication between the agency and



JULIA BERRIS EXAMINES THE WORK AND THE INFLUENCE OF THE CREDIT RATING AGENCIES.

the organisation will mean that all information that the issuer thinks is needed to assign a fair rating will be given to the analysts and could make the difference between being downgraded or not.

Blackwood says: "Historically we have had a good working relationship with the agencies. I think it is fair to say that they have been generally supportive.

"Having a good relationship helps quite a bit. Alongside the analysis, the agencies have to use judgement, so a good and open relationship supported by management integrity will help."

Nigel Phipps, Head of European Regulatory Affairs at Moody's, echoes Blackwood's views and believes that maintaining good communication with issuers provides the agency with an important additional means to deliver quality rating opinions. "We make every effort to reach out to companies and for them to talk to us," he says. "We meet with most of them at least once a year and we have numerous phone conversations with them. We will not publish a rating opinion without trying to check with the company first to make sure we aren't stating anything incorrectly."

David Swann, Group Treasurer at British American Tobacco (BAT), explains that ratings have an influence on the way the BAT treasury department makes decisions and the rating is significant to its business profile. "We provide them with all the information we think they need to make a good decision," he says. "We do have a good working relationship and it involves a bit more than just transferring the information. For example, we have involved discussions around risk."

Rating agencies have been heavily criticised for their use of unsolicited ratings. This contentious issue is one of the reasons why some issuers have put pressure on regulators to impose more regulatory constraints on the agencies. Should agencies be able to issue a rating without permission and the benefit of insider information?

"It has not happened to us, but I think it is difficult to stop someone doing the analysis if they choose," says Blackwood. "However, I think one would expect the opportunity to provide them with additional information to ensure a proper conclusion."

Many take the view that an unsolicited rating is likely to be less favourable to the issuer because the analysts have not had access to all the information that would be available for a solicited rating.

Blackwood argues that solicited ratings involve management discussion and access to all sorts of information that is price-sensitive and confidential. If, as is likely, this is not shared with analysts working on unsolicited ratings, then the rating must be suspect. "Moody's has not assigned unsolicited ratings in the recent past," says Drevon. "However we have always believed that all our ratings provide the same value and quality whether they are solicited or unsolicited. Issuer information is after all only one input to a rating opinion."

Hunter explains how not allowing unsolicited ratings could be bad for the market and would hamper the competition provided by new rating agencies.

"There are two key elements to consider when thinking about not allowing unsolicited ratings," he says. "One is that you are effectively stacking the cards in favour of the ratings that meet an issuer's approval and that is something that those using the ratings would not like to see.

"Second, you prevent any new agencies coming into existence. It would be very hard for a new agency to build up its portfolio if it was unable to do unsolicited ratings."

Encouraging competition in this area of industry seems to be something that most are in favour of. However, Blackwood explains that competition could also be a bad thing in some respects.

"There is a shortage of competition at the moment and it is inappropriate in a market to have so much pricing power," he says. "On the flip side, if there is too much competition you have the potential moral hazard of people going opinion shopping. This would be unhealthy for the market. It is a dilemma between the two, but on balance I prefer more competition."

Swann argues that healthy competition is needed in this area and would enable the process to be shaped by the quality of service. "Investors are a pretty smart bunch, after all, and they will see through those issuers who need to shop around for a good rating," he says. "However, it may take a while for competition to arise."

With the IOSCO code of conduct firmly in place and agencies paying particular attention to transparency and communication with companies, some issuers feel the process has come on in leaps and bounds since the days of Enron.

There will always be scepticism about the validity of unsolicited ratings and a demand from some for more regulation to prevent them, but many investors will continue to use ratings as a valuable and trustworthy guide to help in their investment decisions.

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