IN BRIEF

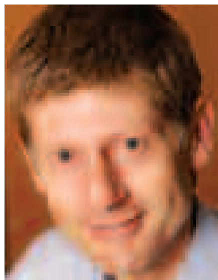
The Credit Rating Agency Reform Act of 2006 has been passed in the US. The Act will abolish the authority of the US financial watchdog, the Securities and Exchange Commission, to designate "nationally recognized" credit rating agencies. Instead, a credit rating company with three years of experience that meets certain standards will be allowed to register with the SEC as a "statistical ratings organization". The Act also grants the SEC new powers to inspect credit rating agencies as well as to keep an eye on potential conflicts of interest and misuse of non-public information, although the body will have no say over rating methodologies. The overall aim of the new law is to improve competition by removing barriers to entry, and to curb abuse.

An EU-sponsored study has recommended a **limitation on lawsuits against auditors** to prevent a large damages award wiping out one of the remaining Big Four firms. European Commissioner for the Internal Market and Services Charlie McCreevy, who is due to speak at the ACT Annual Dinner, acknowledged that a large claim could put the entire auditing network at risk.

Company secretaries in private companies will retain all their powers when the Companies Bill becomes law. Following representations by the Institute of Chartered Secretaries and Administrators, supported by the ACT, the government has announced a change of heart. Rather than water down the powers of the company secretary, the Bill now makes their appointment by private companies non-mandatory.

Fears around the **takeover of major exchanges** have prompted the government to announce it will give the FSA the power to veto proposed rule changes that could be seen as disproportionate, with the aim of preserving the UK's light-touch regulatory regime. This will not prevent foreign ownership of exchanges but will help maintain London's attraction as an international financial centre. Following a meeting of SEC Chairman Christopher Cox and several of his European counterparts, the regulators "stated their shared belief in the importance of the local regulation of local markets".

The UK's listing authority has issued another in its series of factsheets covering topical issues of a non-technical nature. The latest concerns **prospectus passporting**, and points out that a supplementary prospectus can only be passported if the prospectus it relates to has previously been passported out. See: **www.fsa.gov.uk/pubs/ukla/factsheet4.pdf.**



INTRODUCTION

By Martin O'Donovan
ACT Assistant Director, Policy and Technical

These technical update pages aim to provide you with treasury-related news and miscellaneous reports, research and advice, plus a major focus on some of the subjects the ACT is currently working on.

Often these will have been prompted by proposals from outside parties to make changes to rules, regulations, standards or market practices.

It may seem an odd coincidence that the three big credit rating agencies each feature in a main story this month, but it is indicative of a new openness by the agencies to explain their general methodologies.

We welcome the approach and commended the agencies for it in the ACT's recent evidence to the Committee of European Securities Regulators, which has been investigating the conduct of rating agencies. ■

Moody's covenant framework comes under fire from ACT

The ACT has raised a number of concerns with credit ratings agency Moody's about its plans to introduce a covenant research and assessment framework for non-financial issuers (see *The Treasurer*, October, page 8). The agency plans to analyse indenture covenants to provide investors with a formal matrix that would score more highly those covenants that Moody's considers offer greater protection to the bondholder in the event of corporate financial distress.

The ACT believes a formal covenant rating scale gives undue attention to just one component of an overall credit rating, and a very minor one at that. The use of a covenant matrix is also particularly unhelpful because of its inappropriate structure: it cross-references covenants and creates absolute criteria where none currently exists.

A further concern is the likely discovery process for covenants, both in resources and additional costs to issuers – especially in management time. This would apply equally to providing detail on particular covenants to the agency as well as the broader issue of ensuring the appropriateness of individual clauses for the issuer.

On the 'if it ain't broke, don't fix it' principle, the ACT also feels that Moody's current approach to assessment – using the relevant jurisdictional, legal and credit contexts to understand if covenants might affect an overall risk profile – continues to offer value to the credit markets and should not be abandoned or diluted.

Demand for bonds has driven down spreads and long-term yields to historically low levels and the introduction of a potentially confusing rating for covenants is unlikely to change the commercial drive for bond investment. But a general commentary on covenants may encourage investors to review the relevant documentation as part of their investment decision. A commentary would also support wider market attempts – which the ACT has supported – to develop greater transparency as part of the marketing process for debt issuance.

See Moving up a Notch, page 28 ■

Recovery ratings expansion proposed

Credit ratings agency Standard & Poor's has also announced that it is consulting – in its case on ratings recovery. S&P is proposing to expand its global coverage of recovery ratings and to increase the weight of recovery prospects in issue ratings.

If the expansion plans are implemented, S&P expects the number of recovery ratings to increase from 1,600 to over 3,000.

The agency's request for comment paper on expanding recovery rating coverage and enhancing issue ratings details the criteria changes it proposes to make and invites market participants to provide feedback by 1 December 2006.

The S&P consultation paper can be found under the Hot Topic section at the agency's homepage (www.standardandpoors.com).

If you wish to provide comments for inclusion in the ACT's response to the changes S&P has proposed, contact: **pmatza@treasurers.org.** ■

Fitch redesigns the equity credit for hybrid securities

Fitch Ratings has published a new criteria report on equity credit for capital securities.

The agency's approach is to assign ratings to an issuer that reflect the probability of its failure and total default. Hybrids are evaluated as to their likely effect on the viability of the issuer under conditions of financial stress. The key ratings feature of Fitch's analysis is that the equity credit assigned to an instrument is primarily a function of the characteristics of the note rather than whether the issuer is an operating or holding company.

The equity credit is derived from the financial flexibility the hybrid should afford an issuer under periods of financial stress. Accordingly, Fitch requires the security to have one of the following two features to be considered for equity credit:

- The loss-absorbing features of the security (especially the deferral or passing of cash payments without causing a default); or
- Mandatory conversion to equity.

Fitch will approve a security for equity credit as one of five points along a debt-equity continuum that runs as follows:

- Class A 0/100% equity/debt;
- Class B 25/75% equity/debt;
- Class C 50/50% equity/debt;
- Class D 75/25% equity/debt; and
- Class E 100/0% equity/debt.

Previously, Fitch applied credit as a given percentage on the same line. The agency believes the change will bring greater clarity and certainty for particular instruments.

The science of the rating process is contained in Fitch's analysis of the various product features of each instrument:

- The permanence or maturity of the security (including any call features);
- The deferral mechanisms (whether cumulative or non-cumulative);
- Investor protection mechanisms, such as financial covenants or regulatory provisions; and
- The ranking of the security in the event of financial default or bankruptcy.

The application of these features is based on a weak link analysis whereby the equity credit is constrained by the weakest component of the hybrid's features.

Once the level of credit has been agreed, Fitch intends to place a consistent cap – 30% of eligible capital – on the amount of credit derived from hybrids that can be included in an issuer's capital structure. However, it suggests this cap may not be strictly applied in the corporate sector where liquidity tends to outweigh technical measures of equity capital.

The report goes on to explain Fitch's detailed analytical approach to hybrid evaluation, covering loss absorption, convertibility and the features of mandatory conversion, the implications of deferral and the influence of maturity.

In particular, Fitch's analysis addresses alternative coupon settlement mechanisms – for example, the issuance of equity-like securities. These have developed in response to tax authorities requiring cumulative dividends to classify a hybrid as debt and to ensure tax deductions for all cash payments even when some have been missed or deferred.

Hybrids will tend to have very long maturities but may have an issuer call option. If there is a step up in the coupon at that call date, Fitch will treat that date as the effective maturity. Remembering that common equity is perpetual explains why permanence can influence the level of equity credit. A hybrid with an effective maturity of 20 years gives virtually the same reduction in refinancing risk as a perpetual security and can qualify for a 100% credit, while at 10 years' effective maturity the maximum credit is 75%, dropping to zero at less than five years.

The design of hybrids includes loss-absorbing characteristics so that the rating of the hybrid itself will be notched down from the base issuer default rating depending on the hybrid's expected post-default recovery characteristics. For an issuer rating at an investment-grade level, the notching down would be one to two levels, and for non-investment-grade two to three notches.

Overall, Fitch's report is comprehensive and should allow issuers and their advisers to understand the likely outcome of a ratings request when planning for hybrid issuance.

Although business sectors will be affected by regulatory influences and local market practices, Fitch believes its core principles can be applied equally in determining equity credit.

Innovation and development of the asset class will be encouraged by Fitch's hybrid products committee using a review process prior to issuance of any new securities.

To read the full report, search for Equity Credit for Hybrids & Other Capital Securities at: **www.fitchratings.com.** ■

IN BRIEF

From 1 October, the **rules on cheque writing** have been tightened. Cheque writers must include the name or account number of an individual or company as the recipient rather than just a bank or building society. Although only 1.5% of the 1.9 billion cheques written in 2005 were made out in the name of financial institutions, this minority is the target of the new rules. The changes were first announced in December 2005, and the revised procedures are consistent with advice given in the Banking Code.

The ACT has responded to a consultation document issued by the Housing Corporation on **treasury management policy for housing associations**. The consultation is intended to lead to a replacement of the existing policy, issued in 1999, to reflect both proposed changes in the Housing Corporation's regulatory approach and the increasing financial sophistication of many associations. The ACT's response was to support fully the requirement for housing associations to have sufficient professional skills at board and executive level to manage treasury matters and to recommend enhancing regulatory oversight by ensuring greater awareness of the existing *Good Practice Guide to Treasury Management for Housing Associations*.

"Spring Loading" and "Bullet Dodging" feature in the FSA's *Market Watch* newsletter no.17, which provides valuable indications of the authority's thinking. The terms refer to the practice of bringing forward or delaying the timing of the grant of a share option so that the strike price can be set at a more favourable level. If done on the basis of inside information, this could be a market abuse offence for both the person granting the option and the acquirer. See: **www.fsa.gov.uk/pubs/newsletters/mw_newsletter17.pdf.**

Amendments to UK listing and prospectus rules have been published for consultation by the FSA. It wants to deal with a number of areas where the rules may hinder the efficient operation of the market. The net effect of the changes would be deregulatory. See: **www.fsa.gov.uk/pubs/cp/cp06_17_newsletter.pdf.**

This month the ACT's Technical Committee has concluded two EU-related responses, both of which will have a direct impact on the work of treasurers. For the full detail of the responses to the **Payments Services Directive and MiFID client categorisation**, visit the homepage at: **www.treasurers.org.**