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European regulation of credit rating agencies

November 2011 Brief from The Association of Corporate Treasurers

Background history

On 7 December 2010, a new EU regulatory framework applicable to the credit rating sector came into force. These new rules required credit rating agencies (CRA) in the Commission's own words "to comply with rules of conduct in order to minimise potential for conflicts of interest, ensure higher quality ratings and greater transparency of ratings and the rating process."

Even before there had been time for the effect of those rules to be assessed and indeed even before those new rules had had even come into effect, the Commission in November 2010 launched into yet another review of rating agencies citing particular concerns over:

- Overreliance on agency ratings, both in financial regulation and by investors who were failing to do their own due diligence.
- Improving sovereign debt rating because of concerns that a downgrading had the immediate effect of making a country's borrowing more expensive.
- Lack of competition and concentration of power in the hands of just a few agencies.
- Liability – to consider under which conditions civil liability claims by investors against credit rating agencies might be appropriate.
- Conflicts of interest – a concern over the "issuer-pays" model.

The ACT understands that a new credit rating agency regulation is to be announced by the Commission in mid November 2011 as a result of those proposals and consultations. .

Under the existing regulations (2009) registered credit rating agencies have to comply with rigorous rules to make sure (i) that ratings are not affected by conflicts of interest, (ii) that credit rating agencies remain vigilant on the quality of the rating methodology and the ratings, and (iii) that credit rating agencies act in a transparent manner. The Regulation also includes an effective surveillance regime whereby regulators will supervise credit rating agencies.

Prior to this the CRAs operated a self certification under a voluntary Code produced by IOSCO.

Back in 2003 the French (AFTE), US (APF) and UK-based (ACT) treasury associations published a code of conduct for rating agencies http://www.treasurers.org/node/3105 covering behaviours around transparency, confidentiality and conflicts and - notably - including a section on the issuer's responsibilities to be open in provision of information to the agencies.

Companies are rated as issuers or for their general credit standing. Companies and also use ratings in their own activities – not only as part of investing surplus funds but of making judgements about financial counterparties genrally and about customers, suppliers, joint venturers, etc. Anyone who deals a with company will be interested in its corporate rating or ratings of its senior unsecured debt.

Latest proposals

Under the current structure for corporate ratings CRAs provide an excellent channel for issuers to provide information to the market in analysed form, using published and understood methodologies (but, importantly and usefully, somewhat different methodologies for each particular agency) readily understandable by users.

The ACT is fully in favour of the Commission's ultimate intention to improve the functioning of CRAs in the market, where this can be achieved. However, it is our belief, from the perspective of a significant group affected by the work of CRAs, that the Commission's current proposals may be counter-productive for European companies, governments and the European Union as a whole.

The new proposals give the impression that it is the Commission's wish to control the expression of views on credit and reduce the status, independence and professionalism of CRAs. It raises the prospect of an intrusion into the CRAs' independence of methodologies, the element of choice for issuers and what investors and other users need. In summary the ACT is concerned about how this legislation will shape the rating industry to the detriment of the smooth functioning of the debt capital markets, relations between companies and other stakeholders in Europe and the European economy and society as a whole.

Competition

The ACT understands the concerns of the Commission regarding inadequate competition given the low number of international credit rating agencies.

Both issuers and investors and other users would welcome competition in principle – as they bear the costs of ratings and receive the service levels from the agencies. They probably hope that the idea that there could be new agencies will be sufficient to encourage "competitive" behaviour among incumbent agencies. However, in practice the ratings business is inherently unlikely to have many major players: it is naturally oligopolistic due to the resources such an organisation requires.

Investors and other users prefer a small number of providers so that they can gain an in-depth understanding of their various approaches to ratings and get comfortable with their reputation and reliability.

For issuers a significant element of the cost of a credit rating is the management time spent dealing with the agencies. Although the agency fees are material in the context of the department budgets to which they will be charged, they are usually not significant in the context of the overall finance costs of the firm. Accordingly issuers prefer to deal with only a small number of well understood and generally accepted agencies. They might brief the odd specialist agency too. But they will not want the time-cost of educating new agencies frequently, if at all.

It can take many years - several economic cycles - for a new credit rating agency to achieve credibility in a sector. The "bedding-in" period is very long. A new rating agency must see a way to achieve a profitable and sustainable business so as to attract capital to finance itself. During this period it may be hard for a new agency to generate the revenue needed from investors or from issuers and investors to continue. A new rating agency may be more easily introduced as a spin-off from a credit analysis service to investors or a niche or specialist agency that has already built up a reputation among them. The expansion of Fitch to challenge the duopoly of Moody's and Standard and Poor's shows what is possible over time. Even Fitch does not yet cover the whole ratings field in the depth of the other two agencies.

Given this structural background, one would expect persistence of only a small number of major, global credit rating agencies, the constituents of which would be expected to change rarely, if at all.

However, it would be a major contribution to avoid artificial barriers to entry to the market for ratings provision, such as excessive regulation or prescriptive use of certain ratings in regulation or in the standard practices relating to banks or investors or intermediaries or information providers. A varied population of local and specialist agencies may then co-exist with the global agencies and flourish and perhaps a new agency arise to challenge the incumbents.

Under the subject of takeover and ownership restrictions, competition laws already exist and if deficient should be rectified holistically, rather than for one particular business sector only.

Civil Liability

There are several specific proposals now on the table which would create new barriers to entry. The concept of civil liability raises the risk to ratings agencies and would require a much enhanced level of capital to provide a risk buffer. Credit rating agencies are not credit insurers.

The conditions applicable to the subscribers' use of ratings should be dealt with in the contract and it is appropriate, if ratings are to be available at reasonable cost, for agencies to exclude civil liability. It is important that rating agencies not be seen as investment advisors or as owing fiduciary duties to clients. If an investor wants to delegate investment decisions they need to appoint a suitably qualified and regulated investment manager or financial advisor that owes appropriate duties to their clients and is capitalised and insured accordingly.

The capital required to back civil liabilities for honestly produced ratings which ultimately and with hindsight prove inappropriate, or the costs of buying insurance against this are so large that the cost of credit ratings could greatly increase, perhaps prohibitively. It would make establishment of new agencies extremely difficult and threaten existing ones. The effect on competition in the industry would be damaging.

Rotation of rating agencies

Mandatory rotation of rating agencies every three years or after 10 consecutive issues:

We note that the 2009 regulation of CRAs has introduced the concept of rotation of analysts to help avoid conflicts and too cosy a relationship. This has not yet had time to come into effect and be reviewed for effectiveness. The three year rotation rule represents a huge additional burden for the issuer in bringing a new CRA up to speed on its business and loss of industry expertise and familiarity within the CRA itself, despite the concept of a "handover file".
Investors in a bond want to be certain that the bond will continue to be rated for its whole life and on a consistent basis, not subject to discontinuities or even cessation of ratings every three years.

Banning a CRA from simultaneously providing issuer rating and issue ratings:

For the issuer distributing the information to assist the ratings analysis to multiple CRAs again increases the management time required and risks diluting the quality of information made available to the agencies.

There is great risk of a drift away from reliance and use of ratings which cannot be replicated by issuers proving more briefings and disclosures to the markets if the burden for an issuer of dealing with a rating agency becomes too onerous because of frequent imposed changes and if the end product for investors becomes more variable in quality and consistency for investors. The beauty of disseminating information via a rating agency is that confidential information can be provided and used to inform the rating, but without specific disclosure of commercially sensitive information.

Investors and others do not wish to be made insiders in terms of information about listed companies and companies will not wish, or realistically even be able, to disclose commercially sensitive information other than to trusted parties such as the credit rating agencies, even if it does not constitute normally defined “inside information”. Such material digested by the agencies, to avoid direct disclosure of confidential matter, informs the rating and the associated commentaries, reducing informational inequalities in markets and among stakeholders. Without this there would likely be a major reduction in the quality of information being disseminated to the market and other stakeholders, with significant consequent inefficiencies, higher costs both to companies and society as a whole and related risks to markets.

Central database and index

<u>ESMA to make available rating information on a central database including a ratings index and average ratings</u>

This concept appears to be about providing the end symbol rating levels, AAA, AA, A etc which of itself could be convenient for users, but has the unintended consequence of concentrating attention on the rating levels and not on the in-depth reports and analysis the CRAs provide. Emphasising the more detailed reports would be more likely to generate a well informed investor community than giving undue prominence to and reliance on the simple rating levels.

The idea of an average rating is difficult as different agencies’ ratings have different meanings (see next paragraph) and are arrived at through different methodologies, making the information available much richer, The idea of an average improverishes this. Averaging ratings would be like averaging ‘sympathetic’ and ‘tall’ to describe a person.

Harmonisation

<u>ESMA to define a harmonised rating scale</u>

The danger here is that this becomes the start of a trend towards a single government approved form of rating, lacking the diversity of opinion and approach the current structure allows that adds to the richness of the information available. For example, Standard and Poors ratings are default ratings and it issues a separate “loss-given default” rating for issuers with lower (default) ratings,. while Moody’s “notches” the main rating to reflect loss-given default. Harmonisation would reduce the information available from the full set of ratings matter published by each agency. <u>The role of credit ratings agencies is more nuanced than an initial assessment of the Commission’s proposals allows.</u>

<u>ESMA to approve new methodology changes</u>

The ACT’s concern here is that the approval will go beyond confirming that the change procedures have been followed and instead go even to approving actual methodologies. Much of the value of a rating comes from the confidence that the agency has adopted thorough and reasonable methodologies and is truely independent in its approach. Although a state approved methodology would be free from any commercial bias there may well be some doubt as to its political independence. Recent cases of governments blaming trading in CDS for causing a rise in cost of sovereign borrowing were an example of national prejudice triumphing over objective, rational analysis. There can be a range of methodologies that are sensible and introduce diversity in approach that is beneficial to ratings users and wider financial markets. Separating the decision as to methodology (made by the state) from the party with responsibility for applying it (the ratings agency) and standing by the findings would undermine this positive feature of the current system.

In the November 2010 consultation the Commission mooted the ideas that EU National Central Banks would provide ratings for regulatory purposes and that there could be a European Credit Rating Agency. These ideas were eventually dismissed and yet much of the new content and tone seems to be trying to create a similar effect through control by ESMA.

The ACT strongly supports the need for non-interference with the content and methodologies of credit ratings. We were encouraged by previous publications from the Commission that they shared this stance. However, the current proposals look like the start of a changed position that represents yet another barrier for new entrants to the ratings business to overcome, which would undermine the Commission's good intentions for an efficient, well-regulated single market.

Practical considerations

Many of the specific proposals like CRA rotation and multiple ratings requirements assume that there are a large number of credible agencies in the marketplace. In reality that is not the case, with three international agencies having a dominant position. Because many users will generally want to develop full understanding of the methods of a small number of agencies in which they build up trust (while possibly adding specialist agencies for particular sectors) there is unlikely ever to be many internationally active agencies. The proposals are therefore unworkable. We accept that the marketplace is very concentrated and that increasing competition at the margin would be healthy but trying to force issuers to appoint a new player with no track record will not in itself create that competition.

Other

The trend towards greater political control seems to continue into the idea that ESMA should have power to restrict issuance of sovereign debt ratings in certain defined situations: While this is designed to apply when a country is in negotiations on financial assistance so as to maintain an orderly market, banning the flow of information from trusted sources is likely to have the opposite effect, and dramatically so.

The draft proposal contains many detailed provisions which we would argue are counterproductive. The major items debated here cover just a few to indicate the possible unintended consequences.