TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

The Association of Corporate Treasurers

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Comments in response to

Public consultation on Credit Rating Agencies

European Commission, Directorate General Internal Market and Services

05 November 2010

January 2011

1. The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

The ACT comments from point of view of treasurers working in non-financial companies.

2. General

The ACT welcomes the opportunity to comment on this matter.

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Others are better placed to answer some questions and we comment on only a few below.

3. Overview

Credit ratings of debt are very important for both issuers of and investors in debt.

The function of rating agencies is well put by John Kiff, Senior Financial Sector Expert Global Financial Stability Division in the Monetary and Capital Markets Department of the IMF[1]:

> Credit rating agencies aggregate information about the credit quality of various types of borrowers and their financial obligations. The ratings they issue allow many of those borrowers [access to] global and domestic markets they would not otherwise have, enabling them to attract investment funds. As a result, ratings add liquidity to markets that would otherwise be highly illiquid.

Ratings of sovereign issuers are important to other issuers whose own interest costs will often be seen in relation to sovereign issuers' – usually a premium over the sovereign issuers' rates.

Ratings, used by investors, are also used by many who will not buy the issued debt of an obligor but have other exposures to it with significant credit-like aspects. Customers of, and direct and indirect suppliers to, and joint-venture partners with a rated entity will be influenced by the rating. They may all, from time to time, also be interested in credit-protection products (insurance, CDSs, etc.).

Price (interest cost) differences between debt of different perceived credit standings are important in encouraging responsible behaviour of debt issuers as well as that of investors and others. It is important not to try to suppress such cost of debt differences.

Information published by credit rating agencies about an issuer and its obligations – and not just the alpha-numeric codes but the full suite of information – is an important factor, rightly so, in investor and issuer decisions that result in debt price formation, the perception of its liquidity, and so on. Rating agencies can turn data about an obligation into information and this is a socially useful function.

Rating agencies carry out some of the classical banking function of delegated monitors of credit for non-banks exposed to credit risks, without taking the credit decisions. They also support banks in carrying out their classical role.

We think it important that a variety of models for "credit rating" opinions from a number of providers be widely available.

We attach value to the principle that changes should only be mandated if the resulting system will represent a material improvement on the current one.

Key points from answers to consultation questions

- Consultation Section 1: Questions 1-6, 7-11, 12-15, Herding behaviour induced by official references to ratings
    - Using ratings for setting eligibility of the types of securities central banks will buy or take as collateral or for use in liquidity assessment should be added to the potential list of factors that cause over reliance on ratings.

[1] http://blog-imfdirect.imf.org/2010/09/30/end-the-credit-rating-addiction/, 30 September 2010

- Given that, absent special factors, normal default probability ratings should be stable through the normal economic cycle, they may be less pro-cyclical than, for example market based, indicators.

- Consultation Section 2: Questions 16-18, 19-22, Sovereign Debt ratings
  - We strongly support the stated need for non-interference with the content and methodologies of credit ratings set out at the end of the introduction to section 2 of the consultation.
  - Provided that no individual sovereign issuer is a material part of the revenue of a rating agency, given other conflict of interest management requirements on rating agencies we do not think that the theoretical conflict of interest from payment by the issuer arises in practice.
  - We do not see any justification for forcing agencies to disclose their full sovereign rating reports for free. Their rating assessments do provide a wider public benefit so to encourage wider coverage by the agencies it is only fair to allow them to make a commercial return on their work.
  - We see risks with requiring more frequent ratings reviews. Ratings' function is best served if ratings are relatively stable and non-volatile – as opposed to more volatile trading advice from debt investment advisors
  - We find the proposal for three days' notice to sovereign issuers of changed ratings alarming.
  - As sovereign ratings are a synthesis of many things, including several judgements, unlike the more statistical analysis of structured finance, we see great disadvantage in proposals for more public disclosure of assumptions, parameters, limits and uncertainties in sovereign ratings.
  - Only if a single issuer were a material part of agency revenue would we see actual conflict of interest in the "issuer pays" model in sovereign ratings and this seems unlikely

- Consultation Section 3: Questions 23-30, Enhancing Competition
  - We note that more competition has tended to be followed by decreases in ratings quality.
  - We are concerned at the significant role for the state[2] contemplated in some of the ideas presented in this section as we think that would have a negative effect on competition.
  - The key regulatory contribution to competition will be to avoid artificial barriers to entry to the market for ratings, such as excessive regulation or prescriptive use of certain ratings.
  - We do not think that the European region is different, or sufficiently different from other regions to need a special rating agency ("a new, independent, European Credit Rating Agency").
  - Credit rating agencies sponsored by the state in any form would seem to be a new problem rather than any sort of solution.

[2] Including central banks

- We have not seen policy arguments supporting mandatory ratings generally or for its application to particular sectors. This would be such a large change, for issuers and investors and the market generally, that it should be separately consulted on if it is to be considered at all. Mandatory or officially expected use of credit ratings can reduce competitive pressure to maintain the quality of ratings.

- Consultation Section 4: Questions 31-33, Civil Liability of Credit Rating Agencies
  - We think there is a need not to introduce a new principle of civil liability for credit ratings. Credit rating agencies are not credit insurers.

- Consultation Section 5: Questions 34-36, Conflicts of interest under the issuer-pays model
  - We strongly disagree that, in general, there is leverage for fee-paying issuers to influence ratings improperly. The exception is that of structured ratings where a small number of sponsors represented a material part of agency revenues.
  - We agree with the IMF's conclusion[6]: "There seem to be few viable alternative compensation models to an issuer-pay business model in the foreseeable future. In particular, it is not realistic to return to a general investor-pay subscription model."
  - We see no advantages, merely extra cost and inconvenience to investors, from mandatory credit rating purchase by investors.
  - Regarding the proposal to mandate investor owned rating agencies, we do not think that any particular ownership of ratings agencies should be particularly encouraged or discouraged
  - Government allocation of rating agencies may be part of a solution as regards structured ratings. In other sectors the idea would add no value as there is not a problem to be solved, but would add cost and risk and delay for issuers. It would also raise confidentiality and other issues around market abuse.

Responses to consultation discussion and specific questions

For convenience, we have summarised the questions asked in the Consultation below. A full question listing is incorporated in the Appendix for reference.

4. Consultation section 1: Overreliance on External Credit Ratings

We would note another negative effect of mandating use of ratings in regulation etc. Because such regulations seem to assure rating agencies of a significant amount of business, they can reduce the pressure on rating agencies to produce good, certainly useful, ratings in order to win and keep customers. Thus established agencies may be able to trade on their previous reputation rather than have to win it anew with each turn of the economic cycle.

4.1. Questions 1-6, 7-11, 12-15

Herding behaviour induced by official references to ratings

Most investors will tend to see the effect of events on a particular credit as “good” or “bad”. So there is a natural level of “herding” of response and regulation can only hope to avoid increasing this.

Credit ratings will also tend to respond similarly to such events. And a change in a credit rating or ratings can itself be a secondary “event”.

If a significant number of investors for regulatory or for contractual reasons may need to reduce their exposure to an obligor if its credit rating falls or will be able to consider buying if the rating improves, this can make a major herding trigger.

We agree that to reduce herding effects, regulation should avoid specifying ratings thresholds for regulatory consequences and central banks should avoid ratings for setting eligibility for collateral or the types of securities they will buy. Use of ratings should also be avoided in setting required holdings for liquidity purposes. We would see these as areas to be considered additionally to the three identified in the Consultation at the foot of page 5.

However, credit ratings are often a useful shorthand and widely and relatively economically available in these types of consideration and care should be taken before over-restricting their use. The acknowledgement of the need for proportionality on page 7 of the Consultation is welcome.

Non-financial companies in their credit evaluation of financial counterparties will commonly use credit ratings as the start of their consideration, for example for screening purposes, or use them as an important point of comparison in their internal evaluation or in understanding inputs from bought-in credit analysis services. Companies undertaking debt raising are often told by potential investors that they take a similar approach. Given the importance of cost control to avoid reducing the return to the investor, this seems a sensible approach.

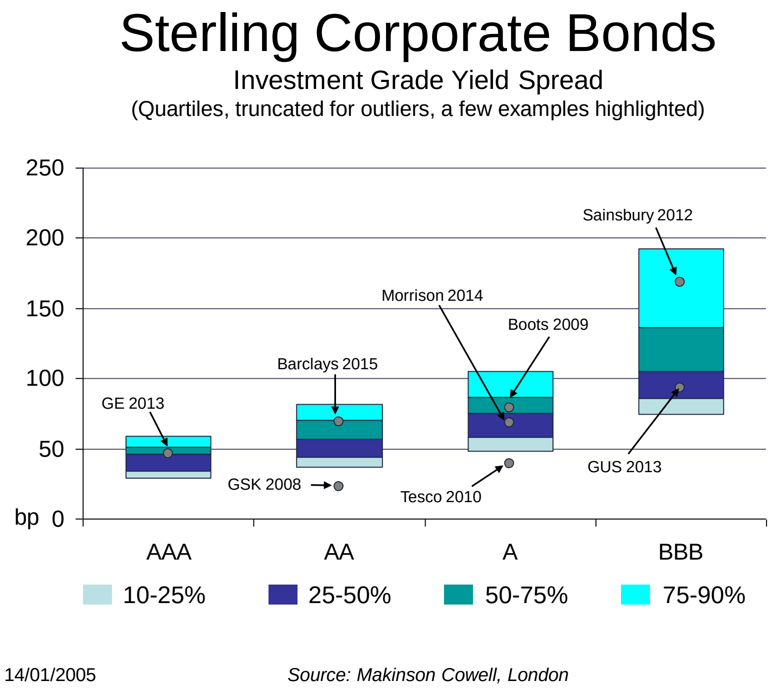
Companies selling credit analysis services to investors seem often to behave similarly in comparing with published ratings, even though doing their own analysis of the obligor. Of course, an obligation that is apparently “correctly” rated and for which the bond price seems to reflect that rating is not of interest to many investors. The investors are looking for value where there is a discrepancy between their/their advisor’s view of the credit and the price of the bond.

Given the foregoing we see that published credit ratings will inevitably have a marked effect in price discovery for debt, irrespective of direct use of ratings in regulation.

4.2. Questions 4 and 14: Alternative measures of credit risk

If consideration is given to alternative measures, we see bond prices as much more significant than CDS spreads. Every day, new issues are priced relative to existing issues and not to CDS. This is not surprising given the small (though often growing) relative size of the CDS market generally and, importantly, the impact on CDS spreads of matters unrelated to the credit standing of the obligor, for example the liquidity and the price volatility of CDS for that obligor and also issues of the credit standing of others to whom the first counterparty can lay off the risk of the CDS if that becomes desirable.

Of course, crude alpha-numeric credit ratings are themselves questionable predictors of the price of an obligation. This is increasingly true as the credit rating falls. Weaker credits are much more dependent on the exact contingencies of the obligor: they are more likely to be “story credits”[3]. An example of how the variation in price grows as credit rating falls is shown in a snapshot of the Sterling bond market in graph 1, below[4].



[3] Of course purely statistical, public information ratings, make no attempt to understand individual corporate “stories”.
[4] This is deliberately taken from before both the financial crisis and the compression of credit spreads, reducing the premium paid by lower rated credits, that took place prior to the crisis.

We do not regard the market based risk measures suggested in the Consultation document as being suitable for use in regulatory frameworks. Using market prices as a measure of credit risk is automatically to build in evaluation using the current conventional wisdom – the prices represent the herd, with all the built in pro-cyclicality at times of euphoria or panic. The prices are not determined by credit risks (risk of default and of loss given default) alone but reflect many other factors as well.

In principle, provided that default probability credit ratings are designed to be stable through a "normal" cycle, with appropriate capital requirements, ratings may be less pro-cyclical than other indicators. This would support the objective of capital requirements of stability at the firm level, contributing to stability at industry level (Q. 4). Similar considerations apply at the mandate level (Q. 14). Regarding the investment policies of investment managers, they are probably looking for price/risk anomalies and will use a wide variety of inputs in making those judgements and it is not desirable to restrict that. Trading between investors with different perceptions, risk appetites, need for liquidity, etc. is an essential part the market.

5. Consultation Section 2: Sovereign Debt ratings Questions 16-18, 19-22

We agree the importance of sovereign debt ratings for the ratings of other entities based in the relevant jurisdiction. The fine-structure of the sovereign rating will be of consequence too, for example the local and foreign currency obligation ratings.

The sovereign rating will also be an important point of reference for pricing the debt of other entities considered here, corporate debt of a given standing generally trading in a range of so many basis points above the sovereign yield to maturity.

We think that the points made in the last two sentences of the introductory discussion of Section 2 of the Consultation are very important.

We note the discussion of the varying charging policies of rating agencies towards sovereign issuers. We do not think this is materially different from the attitude to corporate ratings where some rating agencies will publish unsolicited ratings of some "benchmark" companies in order to give a complete set of ratings to clients who want that for tracking or comparison purposes. We note that more sovereign issuers are seeking ratings or ratings of more of their issues in current conditions. Provided that no individual sovereign issuer is a material part of the revenue of a rating agency, given other conflict of interest management requirements on rating agencies we do not think that the theoretical conflict of interest from payment by the issuer arises in practice.

5.1. Questions 16-18: Enhanced transparency of sovereign debt ratings

Question 16: General ideas (not dealt with in Q. 17 or 18)

Public disclosure of full research reports (Consultation Section 2.1(2))

Because a solicited rating is part of the issuer's communications programme, they would usually like a rating agency to make the report freely available.

Disclosure of the key elements probably strikes a suitable balance and leaves the full report available to the agency's subscribers who are the main market movers in most cases. We do not see any justification for forcing agencies to disclose their full sovereign rating reports for free. Their rating assessments do provide a wider public benefit so to encourage wider coverage by the agencies it is only fair to allow them to make a commercial return on their work.

Where an issuer, here a sovereign, is paying for the rating, there is no reason it should not ask the rating agency to make the full report public (probably for an enhanced fee, as it lowers the value of the agency's subscription service).

Public disclosure of allocation of agency staff to asset classes

We are unconvinced that arbitrarily increasing the number of staff working on a sector necessarily increases the utility of the ratings produced.

We suspect that, if implemented, this proposal would increase the amount of "noise" around ratings rather than being useful information for the market.

Question 17: More frequent rating review (Consultation Section 2.1(4)

In our experience, rating agencies will review ratings between routine reviews if events seem to demand this. Ratings' function is best served if ratings are relatively stable and non-volatile – as opposed to trading advice from debt investment advisors that is supposed to be agile and responsive and immediate. Also more frequent scheduled reviews may tend to cause more points in the calendar when activity becomes more or less difficult as reviews draw near – not only for the sovereign issuer but for all that issue debt linked in some way to the sovereign pricing.

Question 18: Three days' notice to the issuer of revised ratings (discussed in Consultation Section 2.1(1))

Given the importance of sovereign ratings to corporate issuers (see above), we find alarming the proposal for three days' notice to sovereign issuers of changed ratings. Given that some sovereign obligations are traded in more than one time zone the standard twelve hour delay is already a concern. Extending this would give far too large a scope for market manipulation or trading based on information not generally available which would constitute market abuse. Given the nature of the relationships involved, we do not see that it would be practical to limit the information to both the right people and a sufficiently small group of people for such a long period.

We do not consider that a three day delay would correspond to the non-selective and timely disclosure required under Article 10 of the CRA Regulation.

5.2. Questions 19-22: Methodology and process issues

Questions 19 and 22: General ideas (not dealt with in Q. 20 and 21)

Public disclosure of assumptions, parameters, limits and uncertainties (Consultation Section 2.2(1))

We would see this as unpicking the idea of a rating of a sovereign issuer which is a synthesis of many things including many judgements. It is not like the rating of a structured finance instrument where a more statistical approach is more likely to be appropriate. Given the importance of sovereign ratings to corporate issuers we would not welcome sovereign ratings being picked apart for an extended period after issue.

Open meetings and mail boxes (Consultation Section 2.2(2))

We always welcome educational efforts by agencies to explain credit ratings to a wider audience. However, issuers would not welcome open-ended commitments to onerous activity that they would end up paying for.

Question 20: publish sovereign ratings after European close of business

We do not think this would necessarily represent "timely" publication. Our concern is particularly that in the case of debt traded in other markets too, large investors able to respond elsewhere will be advantaged over others. Given bank holidays etc. this could cover multiple trading sessions. Additional delay may increase opportunities for abuse.

Question 21: EU Member States not to pay to for credit ratings

This does not seem to be helpful. A sovereign issuer may want all and not just some issues to be rated while agencies may prefer to be selective on an unsolicited basis. Only if a single issuer were a material part of agency revenue would the potential conflict of interest be actual. This would seem unlikely. But, in any case, is the suggestion that a Member State in that position would in fact be abusive of their position and try inappropriately to influence the agency?

6. Consultation Section 3: Enhancing Competition Questions 23-30

Representing users of ratings and issuers of rated obligations, we are supportive of increased competition in the ratings business as service levels can always be improved and costs reduced. However, we draw attention to competition not necessarily being a way to improve ratings quality – indeed more competition has tended to be followed by decreases in quality[5].

We are concerned in general at the official or state role as envisaged in several of these questions. The implication is that existing ratings are inappropriate in some way, leading to misdirection of investment in debt obligations. Given the large number and wide variety of types of investors involved, some not using ratings, some using credit ratings as part of their decision process this seems unlikely. The thinking behind the questions appears to lean towards state direction of debt investments. It seems unlikely this would be an improvement.

Question 23: Encouragement of new rating agencies
Question 28: Lowering barriers to entry to new rating agencies

We note that the credit rating agency business is inherently unlikely to have many major players: it is naturally oligopolistic.

Investors and other users will want to see a small number of "universal standards" for credit ratings that they understand and can use. Additionally they will use a number of specialist agencies and also analysis firms that look at risk/reward issues and, in some cases, make their own studies. They will compare the results of these with the "universal standards" they are accustomed to. The nature of investment firms and the staff they employ makes a portable standard very convenient.

Similarly, issuers – for which the greater cost of 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 in the context of the overall finance costs of the firm). Accordingly issuers want to be able 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.

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.

[5] See. Becker, Bo and Milbourn, Todd T., How Did Increased Competition Affect Credit Ratings? (September 21, 2010). Harvard Business School Finance Working Paper No. 09-051, available at SSRN: http://ssrn.com/abstract=1278150 at November 2010 and

Bongaerts, Don, Cremers, Martijn, and Goetzmann William, Multiple Ratings and Credit Spreads, paper delivered at a Conference on the Financial Crisis, Centre de Recerca en Economia Internacional, Universitat Pompeu Fabra, Barcelona, 7-8 May 2009 available at http://www.cepr.org/meets/wkcn/1/1716/papers/Bongaerts.pdf at November 2010.

It can take many years, several economic cycles, for a new credit rating agency to achieve credibility in a sector. The "start-up" 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 the start-up period it may be hard for a new agency to generate the revenue needed to continue from investors or from issuers and investors. 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.

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, 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.

Question 24: ECB to provide ratings for regulatory purposes and
Question 25: EU National Central banks to provide ratings for regulatory purposes

While the ECB and central banks might provide ratings for regulatory purposes, it would be unlikely that these would remain confidential for that purpose only.

Circumstances may vary according to whether the central banks (including the ECB) provided all ratings for regulatory purposes or simply an alternative to ratings from others or just ratings for some obligations of some obligors.

If this were widely done, however, unless the ratings were perceived as biased or of poor discrimination or reliability or not updated quickly enough in response to events or in some other way materially deficient, the ratings would provide major competition to commercially provided ratings, displacing other providers. If only central bank ratings were stipulated in regulation this would be even more anti-competitive.

If the central banks were exempted from the requirements of the regulations relating to rating agencies for transparency, potential liability and so on, this would further distort competition and negatively affect other ratings providers.

Of course, credit ratings are merely an (informed and systematically thought out) opinion. But there is the risk that "official" ratings would have a special position in the view of the public. Political pressure from persons incurring losses having taken these ratings into account may grow for compensation from the tax-payers' purse.

We see issues arising from the funding of the costs of the ratings production by the central banks, whether these were produced internally or bought in from external rating agencies by the banks. How users of the ratings were able to influence pricing and service levels is an important and difficult issue.

Given central banks other important responsibilities, un-resolvable conflicts of interest may be seen to arise from ratings generally and, particularly in ratings of obligors from that central bank's region and even more in ratings of sovereign or sovereign related obligors. The conflicts of interest would occur not only in the ratings assessments but in the timing of their review and release.

Centrally provided credit ratings would presumably function like unsolicited ratings from conventional rating agencies – i.e. on a user pay's basis, with no or limited involvement from issuers with no access to non-published information or in depth discussion with management. We can see conflicts arising here too.

Question 26: Member States to establish new credit rating agencies

The issues and conflicts of interest discussed in response to questions 24 and 25 also arise here. The question of officially endorsed ratings would loom even larger.

Question 27: A new, independent, European Credit Rating Agency

We do not think that the European region is different, or sufficiently different from other regions to need a special rating agency presumably using rating models inappropriate for the rest of the world.

If the European region forms a single market, it should be sufficiently large to attract a range of profitable and sustainable ratings providers as any other. If it is not sufficiently large, a new agency of size would presumably require to be operated permanently at a loss. This may not be a good use of tax payer's money. A subsidised agency would have a negative competitive effect on rating agencies generally, potentially displacing some others. The damaging effect would be greatest on newer and smaller agencies, of course.

Availability of start-up funding is an issue for all new businesses. It seems improbable that a strong case could be made that new rating agencies should have access to official funding that is not available to start-ups generally and on similar criteria.

It is difficult to see how a state owned, controlled or sponsored agency is a tool to *increase* competition, even if it were not state subsidised (by intent or practice).

If a new agency were seen as having been set up to be more likely to be influenced by issuers or by governments in the region or by the Commission or the ECB, etc. it would not be credible to investors or for the important role ratings may play in regulation. Such an agency would seem to be a new problem rather than any sort of solution.

From the point of view of issuers the suggestion in the question that they be mandated to obtain a solicited rating from such an agency would be seen simply as an unreasonable additional burden, not just of cost, but of management time.

If such an agency were to be providing only "public information" ratings, the imposition on management time would be lowered and presumably the issuer would not have to pay for the rating. The requirement to "obtain" a rating seems to require something from the issuer, presumably some kind of payment though this is not a requirement for public information ratings at present. This would just be some kind of tax.

Of course, at present not all debt issues are rated and not all companies have general obligation ratings.

A mandatory requirement for ratings would materially change credit markets, particularly for smaller companies that may find it more burdensome.

A general problem with regulatory requirement for ratings, the reduction of pressure for the quality and timeliness of ratings was dealt with at the start of Section 4 of these comments, above.

We have not seen policy arguments supporting mandatory ratings generally or for its application to particular sectors. We think that this is such a large change that it should be separately consulted on if it is to be considered.

See also comments in response to Consultation question 35, below.

Question 28: Lowering Barriers to entry or expansion

See Question 23 above.

Question 29: European Network of Small and Medium Sized Credit Rating Agencies

We see no reason to obstruct the development of a variety of models of ownership of rating agencies, including co-operative models, or of cooperation among them.

The limitations are practical and commercial.

The scope for cooperation is greatest in theoretical analysis to support revision of ratings models and processes. It is least in relation to actual solicited ratings where non-published information made available to a rating agency must be subject to a confidentiality agreement specific to the particular agency which must have in place procedures to maintain that confidentiality.

Issues of potential liability can be difficult for the co-operators.
Again, it is likely to be a slow process to develop the required reputation to establish a network's credibility to be a commercial success.

Question 30: Further measures

We have no further comments on this section.

7. Consultation Section 4: Civil Liability of Credit Rating Agencies

Questions 31-33

Question 31: Need for European principle of liability for credit ratings

We think there is a need *not* to introduce a new principle of civil liability for credit ratings.

Credit rating agencies are not credit insurers.

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 deleterious.

The Consultation notes that decisions that may be influenced by ratings would include decisions to invest or not to invest. Inclusion of non-investment-decision consequences would simply reinforce the point above.

All this is magnified in that the simple ratings and summary ratings reports are often made publicly available without charge so there is no limit on the numbers of investors who could say they have lost out due to ratings.

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 (abdicate?) 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.

We see no distinction in these respects between solicited and un-solicited, public information ratings.

The wide availability of credit analysis at reasonable cost or free is a social good that should be defended, not prohibited. The Consultation cites the refusal of ratings to be used in prospectuses in the US following the Dodd-Frank Act's liability stipulations. The background law is special to the US, but such a chilling effect needs to be avoided in Europe.

Question 32: Standard of fault

While we disagree with the principle, if it were introduced it should certainly be limited to the most extreme and egregious cases involving intent and malice.

Question 33: Liability for solicited as well as unsolicited ratings?

While we disagree with the principle, if it were introduced it should apply to all ratings. If not, whichever type it was applied to would be likely to cease to exist in view of the likely higher costs.

8. Consultation Section 5: Conflicts of interest under the issuer-pays model

Questions 34-36

Question 34: Distorting influence of fee paying issuers

No model is free of conflicts of interest. Under present arrangements, multiple models coexist.

We strongly disagree that, in general, there is leverage for fee-paying issuers to influence ratings improperly.

The reason is twofold:

- First, in most ratings sectors, no single issuer represents a significant part of agency revenue and
- Secondly, rating agencies are required to ensure that the remuneration of their staff is such that individuals are not rewarded in a way that could make them subject to influence in this way.

In rated companies it is commonly the treasurer who handles the relationship with the rating agencies. We have repeatedly asked samples of our membership about how they rate the rating agencies in the quality of their work and their conduct and even those who disagree with the rating of their own firm do not find fault with the agencies.

There is an exception to this picture, however.

In the case of the structured ratings sector while there have been many issues to be rated there have been just a few sponsors to allocate the business to rating agencies. Major sponsors were responsible for far more issues far more frequently than a “normal” issuer would undertake in financing their own business. Accordingly, the major sponsors did represent a significant part of agency income. Rating shopping seems likely to have been a credible threat to the agencies. We think that was an apparent manifest conflict of interest although we are not placed to say if it actually had any effect on ratings.

Certainly in the corporate ratings sector and we presume in the sovereign and financial services industry ratings sectors, the conflicts could exist in theory but do not exist in practice due to the larger number of issuers, the relative infrequency of issuing and the absence of sponsors responsible for a large number of issues.

If there is indeed a potential public mischief in the structured finance sector, that is where concern should be directed.

Question 35: Options and alternatives

Credit ratings came into use in Europe comparatively recently, growing slowly from the late 1970s. It is unlikely that the industry in Europe has yet arrived at its long-term persistent structure. However, we agree with the IMF's conclusion[6]: "There seem to be few viable alternative compensation models to an issuer-pay business model in the foreseeable future. In particular, it is not realistic to return to a general investor-pay subscription model."

We consider below individual alternatives discussed in the Consultation.

- Institutional investors mandatorily to obtain own ratings (Discussed in the Consultation at 5.1.a)

  (See also the discussion of mandatory ratings in response to Consultation question 27, above.)

  In the proposal to mandate that investors must acquire their own rating before buying a debt obligation the Consultation says that this would mean there would be two compulsory ratings – that paid for by the investor and that paid for by the issuer.

  Credit ratings are not at present mandatory for debt issuers. The Consultation assumes a major change that would be sufficiently significant for it to justify separate consultation. Certainly we do not think that mandatory ratings would be welcome to many issuers.

  As regards mandating investor-paid-for ratings, presumably these would be public information (unsolicited) ratings, without the cooperation of the issuer. Issuers would be reluctant to give unpublished information to a rating agency not of their choosing and the demand for management time would also make this impractical: with many investors in some issues, they may choose a number of rating agencies.

  With many investor models using various approaches to credit risks in investments, we see no advantages, merely extra cost and inconvenience to investors, from mandatory credit rating purchase by investors.

  The consultation notes that a subscriber-pays model has not yet developed.

  On the contrary, historically the subscriber pays model was originally dominant where ratings were used. The entrenched dominance of issuer pays in the US developed as demand for a larger universe of rated issues as opposed to unrated issues rose. It was fully established after the Penn Central collapse in 1970 although the subscriber pays model continues in smaller agencies.

  Wide use of credit ratings in Europe developed in the last quarter of the 20th Century.

  When more European issuers turned to US markets for finance in the late 1970s (initially for commercial paper and longer term obligations too) they naturally turned to the issuer pays model to get their issues rated and so satisfy US investors' interest in issues with ratings. The main US rating agencies had opened European offices by the mid 1980s.

[6] International Monetary Fund, Global Financial Stability Report, | October 2010 at page 97.

European investors starting to increase use of credit ratings' in the 1980s naturally used the available issuer pays ratings. However, there is still significant investment in un-rated issues in Europe. And investors do contribute a portion of agency incomes as they subscribe for access to the full coverage by the agencies.

The subscriber pays model is not dead (US) and has not totally failed to develop (Europe), however. But it takes the form of private ratings, not publicly available, and not with alpha-numeric ratings summaries but longer credit analyses. One could cite as larger examples the Egan-Jones Rating Company[7] in the US for the former and CreditSights[8], originating in the US but now also in Europe, the Middle East, Asia and Australia. There are many smaller, niche firms too.

Subscriber pays does not, of course, generate publicly available ratings and does not quite carry out all the functions of issuer pays ratings.

Ratings coverage will be limited under investor pays models. Some rating agencies will rate debt (and provide some "general corporate obligations" ratings) of some issuers in order to have covered a sufficiently wide selection of issues and issuers to tempt potential users to subscribe to their ratings. But once that "critical mass", which will vary from rater to rater, has been achieved, raters will tend not rate additional issues/issuers unless they are sufficiently of interest to their clients for this to be worthwhile.

As the Consultation notes, the coverage of smaller and less liquid issues will be limited. Most raters will cover the largest and most liquid issues.

- Mandation/encouragement of investor owned/controlled agencies (Discussed in the consultation at 5.1.b)

  Here too, issuers would be reluctant to divulge non-published information to rating agencies not of their choosing and the scarce resource to issues of management time is again significant. So these would be likely to be public information ratings.

  There is danger in seeking "prudent, even sceptical ratings". Credit ratings are normally groupings of expected default probabilities over a certain period, sometimes including consideration of expected loss given default. Ratings should correspond with the ratings methodologies and classifications published by the rater. Investors should be free to choose ratings from those whose methodologies they consider most apposite for their needs and these needs may vary by sector and by geography too.

  That said, who would want imprudent, credulous ratings? Even more, who would want to pay for them? Rating agencies ruin their business if they stray towards imprudence and credulousness. We do not think that ownership of the agencies changes what they aim for in the way suggested.

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[7] See http://www.egan-jones.com/. Their tag line is "Accurate Ratings with Predictive Value".
[8] See https://www.creditsights.com/research.htm. Their tag line is "Research that guides your investment and risk management decisions".

However, as in our response to previous questions, we do not think that any particular ownership of ratings agencies should be particularly encouraged or discouraged. The more models that are tried the more we learn about what works. But we would not expect to see a rapid or persistent increase in the number of major agencies for the reasons set out above.

- Groups of investors hiring independent agencies at a discount

  There may be an opportunity for a number of small investors that would be unlikely to pay themselves for custom ratings to cooperate in this way. In a sense this would increase the customer base of the rating agency/ies the group of investors chooses. Consortium buying by large investors may be less viable long-term.

  As the consultation notes, these would be unsolicited ratings.

  There seems to be no obstruction to this model developing, if there is demand for it.

- Payment-upon-results model (Discussed in the Consultation at 5.2)

  Evaluation of credit ratings “over time” is not easy.

  Many ratings are of long term, even very long term, obligations. But this is not the only factor requiring a very long time period to evaluate ratings.

  During the years of the “great stability” in a run-up to the financial crisis, credit ratings may have performed differently from how they performed during the crisis. One can only properly evaluate a rating methodology over many years, involving a range of types of crisis and affecting a wide range of sectors. This is far longer than a rating agency needs for its income to be sufficient. To be viable, agencies would need to recover the equivalent of all the income they would currently expect “up front” and would greatly discount the future income (with interest, inflation protected, etc.?) to come many years into the future.

  We doubt if this is practical.

- Trading venues pay model (discussed in the Consultation at 5.3)

  Obligations may be listed/traded on more than one trading venue. Again, the multiplication of ratings with associated costs is not a minor factor.

  And, again, these would be public information ratings.

- Government as hiring agent model (discussed in the Consultation at 5.4)

  We note that the US model for central assignment of agencies to provide initial ratings is for structured finance ratings. This, together with some other measures, addresses the ratings sector where, as noted above, there is concern about the influence of issuers paying rating agencies as the number of sponsors of structured finance is small.

This is a brave attempt in the US to deal with a narrow problem. It will be difficult for the SEC to design the implementation. Particularly the design of a remuneration system to secure attention to ratings quality and timeliness will be hard. There will be significant extra cost. We wonder if an initial rating which will not be maintained and updated will have the required credibility to be useful.

As discussed elsewhere, the issues arising in the structured finance sector, particularly the threat of ratings shopping, are not such a concern in other sectors.

The problems with introducing such a system for ratings sectors other than structured finance ratings would seem to be greater given the larger number of contingencies affecting potentially the rating of a non-financial company or a sovereign issuer or a diversified financial sector company. These factors make maintenance of a rating and the access to management and non-published information with a solicited rating more important to investors.

Issuers would not welcome the extra cost (of the additional initial rating) that, we presume, they would have to meet.

While the assigned rating agency would probably be undertaking a “public information” rating, the knowledge that the issuer is contemplating such an issue may itself be sensitive and an appropriate confidentiality undertaking/requirement would be necessary. This would also need to cover the use of the knowledge in other parts of the firm – such as public information credit ratings for the issuer or dependent (as guarantor, perhaps) on the issuer’s credit rating.

In summary, the application of this concept outside the structured finance sector would add no value as there is not a problem to be solved but would add cost and risk and delay for issuers.

Question 36: Other alternatives

Given the existing requirements for credit rating agencies we do not see the need for alternative proposals outside the structured finance sector.

Question 37: Other issues

It is important to ensure that regulation is proportionate to the costs, direct and indirect of implementation and the public mischief that the regulation seeks to address.

There are no other issues we would draw to you attention.

Appendix

Consultation questions in full (headings added)

1. Over reliance on External Credit Ratings

1.1. Reference to external ratings in regulatory capital frameworks for credit institutions, investment firms, insurance and reinsurance undertakings

(1) Should the use of standardized approaches based on external ratings be limited to smaller/less sophisticated firms? How could the category of firms which would be eligible to use standardised approaches be defined?

(2) How do you assess the reliability of internal models/ratings? If negatively, what could be done to improve them?

(3) Do you agree that the requirement to use at least two external ratings for calculating capital requirements could reduce the reliance on ratings and would improve the accuracy of the regulatory capital calculation?

(4) What alternative measures of credit risk could be used in regulatory capital frameworks? What are the pros and cons of market based risk measures (such as bond prices, CDS spreads) compared to external credit ratings? How could pro-cyclical effects be mitigated if market prices were used as alternative measures of credit risk in regulatory capital regimes?

(5) Would it be appropriate to restrict institutions'/insurance or reinsurance undertakings' investment only to those securitisation positions for which capital requirements can be reliably assessed? To what extent could the requirement to internally rate all or at least most underlying exposures restrict the potential investor base for securitisations?

(6) Can the existing "supervisory formula" based approach in the Capital Requirements Directive be considered to be sufficiently risk sensitive to become the standard for all securitisation capital requirements? If not, how could its risk sensitivity be improved without placing reliance on institutions' internal estimates other than default probability and loss for the underlying exposures? In the insurance sector, how do you assess the approach to credit risk for structured exposures used in QIS 5?

1.2. Use of external ratings for internal risk management purposes

(7) Should firms be explicitly obliged to carry out their own due diligence and to have internal risk management processes in place which do not exclusively rely on external ratings?

(8) What information should be disclosed to supervisors in order to enable them to monitor the internal risk management processes of firms with particular focus on the use of external credit ratings in these processes?

(9) To what extent do firms currently use credit risk models for their internal risk management? Are the boards of directors or other governing bodies of these firms involved in the review of the use of credit ratings in their investment policies, risk management processes and in investment mandates?

(10) What further measures, in addition to the disclosure proposals included in Articles 8a and 8b[9 (41 in original)] of the proposal amending the current CRA Regulation could be envisaged?

(11) Would you agree with the assessment that sovereign debt ratings are primarily based on publicly available data, implying that rating agencies do not have advanced knowledge? Do you consider that all financial firms would be able to internally assess the credit risk of sovereign debt?

1.3. Use of external ratings in the mandates and investment policies of investment managers

(12) Should there be a "flexibility clause" in investment mandates and policies which would allow investment managers to temporarily deviate from external rating thresholds (e.g. by keeping assets for a limited time period after a downgrading)?

(13) Should investment managers be obliged to introduce measures to ensure that the proportion of portfolios that is solely reliant on external credit ratings is limited? If yes, what limitations could be considered appropriate? Should such limitation be phased in over time?

(14) What alternative measures of credit risk could be used to define the minimum standard of credit quality for a portfolio? Are rolling averages of bond prices/CDS spreads a suitable risk measure for this purpose?

(15) What other solutions could be promoted in order to limit references to external credit ratings in investment policies and mandates?

2. Sovereign Debt Ratings

2.1. Enhance transparency and monitoring of sovereign debt ratings

(16) What is your opinion regarding the ideas outlined above? How can the transparency and monitoring of sovereign debt ratings be improved?

(17) Should sovereign debt ratings be reviewed more frequently? If so, what maximum time period do you consider to be appropriate and why? What could be the expected costs associated with an increase of the review frequency?

(18) Which could be the advantages and disadvantages of informing the relevant countries three days ahead of the publication of a sovereign debt rating? How could the risk of market abuse be mitigated if such a measure were to be introduced?

[9 (41 in original)] Articles 8a and 8b of the European Commission Proposal on amending Regulation (EC) No 1060/2009 on credit rating agencies of 2 June 2010, COM (2010) 289 final. The proposal introduces an obligation on issuers of structured finance instruments to provide access to the information they give to the credit rating agency they have appointed, to all other interested credit rating agencies.

2.2. Enhanced requirements on the methodology and the process of rating sovereign debt

(19) What is your opinion on the need to introduce one or more the proposed measures?

(20) More specifically, could a rule, according to which credit ratings on sovereign debt would be published after the close of business of European trading venues be useful? Could such a rule be extended to all categories of ratings?

(21) Could a commitment of EU Member States not to pay for the evaluation by credit rating agencies reduce potential conflicts of interest?

(22) What other measures could be considered in order to enhance investors' understanding of a sovereign debt rating action?

3. Enhancing Competition in the Credit Rating Industry

(23) How could new players be encouraged to enter the credit rating agency sector?

(24) Could it be useful to explore ways in which the ECB would provide ratings to be used for regulatory purposes by European financial institutions? If yes, which asset classes (corporate, sovereign, structured finance instruments etc) could be considered?

(25) Could it be useful to explore ways in which EU National Central Banks would be encouraged to provide in-house credit rating services? Could the development of external credit rating services also be considered? If so, which asset classes (corporate, sovereign, structured finance instruments etc.) could be targeted? What are the potential advantages and disadvantages of this approach?

(26) Could it be useful to explore ways in which Member States could be encouraged to establish new credit rating agencies at national level? How could such agencies be structured and funded and what entities and products should they rate? What are the potential advantages and disadvantages of this approach?

(27) Is there a need to create a new independent European Credit Rating Agency? If so, how could it be structured and financed and what entities and products should it rate (corporate, sovereign, structured finance instruments)? Should it be mandatory for issuers to obtain ratings from such a credit rating agency? What are the potential advantages and disadvantages of this approach?

(28) Is further intervention needed to lower barriers to entry or expansion in the credit rating agency sector in general or as regards specific segments of the credit ratings business? What actions could be envisaged at EU and at Member State level?

(29) Would the creation of a European Network of Small and Medium Sized Credit Rating Agencies help increase competition in the credit rating agency sector? What are the potential advantages and disadvantages of this approach?

(30) Do you consider that there are any further measures that could be adopted to enhance competition in the rating business?

4. Civil Liability of Credit Rating Agencies

(31) Is there a possible need to introduce a common EU level principle of civil liability for credit rating agencies?

(32) If so, what could be the appropriate standard of fault? Should rating agencies only be liable for gross negligence and intent?

(33) Should such a potential liability regime cover solicited as well as unsolicited ratings?

5. Potential Conflicts of Interest due to the "Issuer Pays Model"

(34) Do you agree that there could be a distorting influence of a fee-paying issuer over the determination of a credit rating?

(35) What is your opinion on the proposed options/alternatives to reduce conflicts of interest due to the "issuer-pays" model? If so please indicate which alternatives appear to be the most feasible ones and why.

(36) Are there any other alternatives to be considered? If so please explain.

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(37) Are there any other issues that you consider should be tackled in the forthcoming review of the CRA Regulation?

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