The Association of Corporate Treasurers

Comments in response to
Standard and Poor's, Request for Comment:
Expanding Recovery Ratings Coverage and Enhancing Issue Ratings
October 2006

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The Association of Corporate Treasurers (ACT)

Established in the UK in 1979, The Association of Corporate Treasurers is a centre of excellence for professionals in treasury, including risk and corporate finance, operating in the international marketplace. It has over 3,600 members from both the corporate and financial sectors, mainly in the UK, its membership working in companies of all sizes.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education. The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

General

The ACT welcomes the opportunity to comment on this matter. Contact details are provided at the end of this document.

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Overview

We are pleased to have an opportunity to respond to your paper "Request for Comment: Expanding Recovery Rating Coverage And Enhancing Issue Ratings". Our comments primarily reflect the considerations of an issuer, although the issuer view must itself take account of the investor perspective and the overall functioning of the market, and indeed we recognise that corporates are also investors and users of ratings.

In summary, our understanding is that the proposal involves expanding recovery rating coverage both by blending default and recovery prospects reflecting a revised 'notching' framework – raising or lowering a specific issue rating from that of its issuer credit rating – and by extending the range of issuers and instruments rated in this way.

Response to specific questions

We have responded directly to those questions you have raised which have particular relevance to our members, with additional comment where appropriate.

- *What are your views on incorporating absolute recovery more fully into issue ratings via a revision of notching criteria*? *Should there be a more direct move to an expected loss framework?(Q1 and Q2)*

  The ACT is broadly supportive of the proposal both in terms of the principles involved and the graduated nature of the approach. In essence the proposed approach is based on expected loss, but presented using the familiar rating scales AAA, AA etc..

- *What are your views on expanding the universe of coverage for speculative-grade issuers? Should the framework cover all investment-grade issuers What about the impact on other markets / instruments, e.g. preferred stock/equity hybrids and emerging markets (but only with well developed insolvency regimes)* ? *Is there a need to expand coverage to public finance issuers in/outside the US?(Q3 and Q6)*

  The analysis relies heavily on historical statistical detail regarding incidence of default and subsequent recovery. Our concern would be whether there is sufficient credible data to allow for comprehensive analysis over all the asset classes suggested. In addition we feel that expanding the full analysis to investment grade issuers and issues is unnecessary except where there are clear indicators of recovery preference as noted, e.g. first-mortgage bonds. Investment grade issues will have a low probability of default therefore considerations of recovery amounts given default will not weigh heavy in investor considerations. There would appear to be limited impact on stock/equity hybrid instruments or on emerging market debt. Again, the collation of default / recovery stats would require further research. We do not feel there is a need to expand coverage to public finance issuers outside the US.

- *Do you have comments on the 7-point recovery scale?(Q4)*

  A 7 point scale would seem to give a reasonable degree of gradation. An extended scale would introduce excessive and probably spurious accuracy. The issue here is less the modest change to scaling but rather the re-basing around a 50% assumed average recovery tendency. Our concern is whether this is perceived to be in support of changing the notching scale or represents substantive experience in recovery rates. Intuitively, notching an issue rating up one notch when the expected recovery is in the range 80% to 100% feels wrong. Without detailed knowledge a user might assume that a base of 100% recovery would be used so that stronger expectations of 100% recovery give rise to upward notches and anything less than 100% gives rise to downward notching. However if a 50% recovery level represents the median level bases on historical experience than your proposed scales and notching criteria make good rational sense, and with time the market will no doubt become familiar with the approach.

- *Will the proposals affect the use of ratings for regulatory purposes and investment guidelines?(Q8)*

  Elements of recovery are already contained in the Basel II capital regimes for financial institutions which would suggest increasing regulatory interest. However, it is likely that investors in sub-investment grade instruments will take only a marginal benefit from this enhanced service given the likelihood that they may already perform their own comprehensive internal credit analysis.

- *Consideration of alternative approaches: a)expansion of coverage with retention of existing notching; b) default and recovery indicators for issues rather than combining them into a single rating, which would eliminate notching by having issue/issuer ratings the same with differential recovery rating.(Q10)*

  Given our comments above on changing the notching scale our preference would be for an interim period of expansion of the coverage before changing the notching regime. This would allow further time for data to accumulate and for the market to appreciate the more widespread coverage.

Conclusion

Our conclusion would be that in principle we support this expansion of recovery ratings coverage and the move towards a more quantifiable ‘expected loss’ regime. However we have some concerns about the quality of the underlying data especially for asset classes more distant to established markets.

We have not commented on the proposed changes to structured finance ratings.

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