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UNICE COMMENTS ON CESR`S CONSULTATION ON POTENTIAL REGULATORY APPROACHES FOR CREDIT RATING AGENCIES

General comments

Accurate ratings are in the interest of issuers and investors alike. Ratings are vitally important in helping companies gain access to finance. They are also essential in helping investors assess the risks involved in purchasing securities and in lending to a borrower, mitigating a situation of potential asymmetric information between the issuer and the investor and amongst different investors. They contribute significantly to the transparency of national and international capital markets, creating higher market liquidity and lower cost of capital for companies. This is important in particular for the smaller, less frequent issuers. Ratings also play an important role for businesses and others when evaluating counterparties for financial transactions, in evaluating actual or potential suppliers or customers for non-financial goods and services, and in similarly evaluating partners, collaborators, or joint venture prospects.

Both investors and issuers are affected by undue price fluctuations in securities that arise if rating decisions cannot be justified by underlying fundamental company data. To price an issuer's creditworthiness and the relevant securities correctly, credit rating agencies (CRA) must provide accurate and fair ratings. Ratings that are recognised by market participants as credible can reduce the premium investors demand for uncertainty about the creditworthiness of an issuer.

The need for reliable ratings has increased in recent years for two reasons: first, financial markets have become increasingly international, with a plethora of products that reduce transparency for the investor. Second, due to the new capital requirements for banks under the Basel-II standards, a company's rating has become an increasingly important factor influencing borrowing costs.

However, there have been a number of incidents over the past years that have led to concerns among market participants regarding the accuracy and reliability of ratings. In

particular, investors and issuers have not always been able to retrace and validate how CRA came to a specific rating decision. For these reasons, there is an important need to establish greater market acceptance and trust in the quality of CRA's rating procedures and decisions.

Against this backdrop, UNICE welcomes the recent IOSCO code of conduct for CRA's business. UNICE believes that self-regulation of the CRA industry should be given priority over formal regulation at this point. The IOSCO Code should form the basis of a stringent CRA industry-wide code of conduct, compliance with which should, for the time being, remain in the responsibility of the CRA. The European Union should not deviate from the IOSCO standards as this could make access to global capital markets more difficult for European issuers.

In the US, based on the work of IOSCO, the SEC is developing a code of conduct for CRA, which will address these concerns. We would therefore encourage the EU Institutions and CESR (the Committee of European Securities Regulators) to monitor and push for the development and enforcement of such a code of conduct, in close coordination with the work done internationally by IOSCO and the SEC. International coherence is important in this area. UNICE welcomes the institutionalisation of the dialogue between CESR and the US Securities and Exchange Commission introduced in June 2004 as this will lead to better access to all capital markets for European companies.

A. The competitive dimension

In UNICE`s view there is no need for a formal registration requirement for CRA. As CESR rightly points out, any type of registration/regulation regime would imply either a duplication of compliance requirements by CRA in parallel to the procedures foreseen under the proposed EU Capital Adequacy Directive, or potential inconsistencies between requirements at a global level and those at EU level.

UNICE agrees with CESR that criteria set by national governments or regulators for recognition may constitute a barrier to entry for potential competitors in the credit ratings market. This risk weighs more heavily than any positive effects on the quality of the ratings used that can be expected from a registration requirement based on sound economic criteria.

There is no trade-off between lower barriers to entry in the ratings market and better quality of ratings. Rather, an increase in competition will promote market-led improvements in quality.

The proposed EU Capital Adequacy Directive foresees that for the purposes of regulatory capital requirements banks and investment firms must use ratings by CRA that have been formally recognised by EU regulators. From the point of view of European companies it is vital that regulators in all countries concerned agree on one set of criteria for recognition of CRA in the context of Basel-II requirements. Ratings from those CRA that have been approved according to these criteria should then be permitted for all relevant legislation that foresees the use of ratings.

The criteria on which these recognitions are based must reflect the general expectations market participants have with regard to the conduct of CRA. These are set out below.

B. Rules of conduct issues

1. CRA Independence and Avoidance of Conflicts of Interest

In order to avoid conflicts of interest which might adversely affect the credit rating, CRA's business must reflect a clear separation in terms of organisation and personnel of the rating business from other services, in particular revenue-raising advisory and ancillary services, in order to avoid undue influence on rating analyses. This must be clearly documented in CRA's internal procedures and laid down as a requirement in an industry-wide code of conduct such as developed by IOSCO.

CRA must have clear procedures in place, established in writing and disclosed to the public for dealing with instances of non-compliance. In line with IOSCO Fundamental 2.6., UNICE believes that CRA must adopt written internal procedures the purpose of which would be to "identify and eliminate, or manage and disclose" on a systematic basis, and not just "as appropriate," potentially harmful conflicts of interest of relevant persons involved in the rating procedure that might impair the objectivity of the rating process. These procedures must be disclosed to the public. In addition, it should be clearly defined in the code of conduct what constitutes "potentially harmful conflicts of interest".

CRA must publicly disclose any actual and potential conflict of interests. This relates in particular to simultaneous advisory or ancillary and rating services provided to the same client. In UNICE's view, CRA should regularly disclose their advisory mandates. However, it does not seem necessary to prohibit a credit rating agency from carrying out ancillary services altogether in order to guarantee a fair credit rating process.

2. Fair presentation and Quality and Integrity of the Rating Process

Issuers and investors must be in a position fully to understand how an agency's rating decision is constructed. Thus, ratings must be objectively verifiable as regards the methodology and the procedure used. While UNICE does not see many advantages in regulating any aspect related to the methodologies and procedures, CRA should firmly commit themselves in a code of conduct to the following principles:

- CRA must publish information about their rating definitions, criteria, methodologies and procedures so that issuers can retrace the steps an agency took to arrive at its decision;

- CRA analysts and rating committees must apply the CRA's rating definitions, criteria, methodologies and procedures as they have been established in writing;

- Any change in criteria, methodologies and procedures must be disclosed publicly before being applied to a specific rating procedure so that issuers have the opportunity to assess the implications of such changes on their rating;

- While regional specificities such as differences in business models or taxation systems must be taken into consideration by CRA, their methodologies must lead to internationally comparable rating results;

- Issuers should at all times be informed about the timetable and the different stages of the rating procedure.

The final IOSCO Code of Conduct does take these elements into account and should serve as an example for an EU approach.

Overall, ratings should reflect the long-term creditworthiness of a company. They should not be changed in response to new data reflecting developments in a company that are short-term.

At the same time, in the interest of issuers and investors alike, the independence of rating agencies in choosing their preferred methodology and procedure should not be called into question. The trial and error process and the competition between different methodologies used by different agencies should ultimately improve the quality of rating decisions.

3. Relationship between issuers and rating agencies

An effective, self-regulatory code of conduct must, in UNICE´s view, contain clear rules governing the relationship between issuers and CRA. This regards in particular communication between the parties and the issuer's right to review a rating decision before it is disclosed to the public and the right to appeal a rating decision.

Issuers should provide accurate and complete information to CRA in order to enable them to make a reliable rating decision. They should notify CRA in a timely manner of new relevant information related to issues that may arise during the rating process. A useful, market-led framework for issuers' and CRA's obligations towards each other can be found in the recent Exposure Draft by the treasurers and finance associations.[1]

- **CRA's information requirements**

CRA must advise issuers before the beginning of each rating procedure of the considerations, information and methodologies on which it plans to base its rating and of new info that might lead to a re-rating. This relates also to changes to the rating methodologies and criteria which must be disclosed prior to undertaking a rating revision. Issuers must be given the opportunity to respond with a commitment by the CRA to take this response into account during the rating procedure.

The CRA must also inform issuers about the expected timeframe of the procedure, in particular with regard to management meetings and rating committee meetings. UNICE would welcome the commitment to regular meetings between issuers and CRA in order to assess actual and potential company developments and key criteria that rating decisions are based on. When disclosing partial ratings, CRA should outline scenarios for the rated company that might lead to an improvement in the rating. It should be evident to the issuer by what measures he could achieve a higher rating.

- **Issuers' right to review and to appeal**

A code of conduct must provide for the right of issuers, within a well-defined period of time, to review and to appeal a rating determined by the rating committee and intended for release and any related documents such as press releases before they are published by CRA. IOSCO Fundamentals Part 3 should be adjusted to that effect. The issuer's review should focus on whether the CRA has based its rating decision on correct and complete data and

[1] Association of Corporate Treasurers/Association for Financial Professionals/Association Francaise des Trésoriers d'Entreprise, Exposure Draft: Code of Standard Practices for Participants in the Credit Rating Process, April 2004.

facts, whether it has followed its methodologies as they have been established in writing and made public and whether the text intended for release contains any non-public information. To that effect, a CRA should inform the issuer wishing to review a rating decision of the information and the considerations on which it based its decision. Ratings should not be released before the issuer has had sufficient time to decide whether it wants to appeal the rating decision.

Issuers must have the right to ask for a new rating review from a rating committee consisting of officers that were not involved in the initial rating action. These officers should convene new meetings with the issuer prior to the re-assessment. IOSCO Fundamentals Part 3 should be adjusted to that effect.

- **Treatment of confidential information**

CRA must adopt internal procedures to prevent unauthorised use of confidential non-published and price-sensitive information as defined by the EU Market Abuse Directive provided to them by the issuer. They must have provisions in their internal procedures to prevent the disclosure of confidential information to third parties.

In general, giving inside information such as defined in the EU Market Abuse Directive to a CRA should not trigger public disclosure requirements for the issuer. Similarly, CRA should not be obliged to make public information about an issuer coming into their possession and which the issuer is obliged to disclose. This would hold back disclosure to rating agencies under normal contracts of confidentiality. Information of a type normally disclosable may not be disclosable under exceptions included in a relevant jurisdiction's regulation or under discretion residing with the appropriate regulator.

- **Unsolicited ratings**

As unsolicited ratings are based solely on public information, CRA need to disclose systematically whether a rating has or has not been solicited by the issuer. Issuers must have the right to be informed about the process of an unsolicited rating and they must be given the opportunity to comment. UNICE agrees with CESR that unsolicited ratings, on the condition that they are disclosed as such, may offer new entrants in the credit ratings market a possibility to build a reputation.

In general, from the point of view of European companies` access to capital markets it is of vital importance that CRA avoid any unnecessary rating action at times when the issuer

intends to access the capital markets without a corresponding request for a new rating and where such a rating action could make this access difficult.

4. Compliance and enforcement

If an industry-wide code of conduct subjects CRA and their staff to clearly defined requirements, it will in UNICE's view have an important disciplinary effect. Therefore, as a first step, it may be advisable to rely on a purely self-regulatory approach to compliance monitoring and enforcement.

In order to ensure the effectiveness of such a code of conduct based on the IOSCO principles, each CRA must designate a senior experienced officer to verify that procedures with regard to rating definitions, criteria, methodologies and procedures are complied with. This officer should be accessible to companies wishing to appeal a rating decision. He could deal with such cases as differences in the methodological approaches with regard to partial and overall ratings, diverging views about the comparability of different issuers from the same sector or deviations of final rating decisions from those originally anticipated. Issuers' appeals and complaints registered with this officer should be published by CRA on a regular basis.

This officer should not have been involved in the rating of the company in question. His/Her role should be clearly defined in the code of conduct.

The effectiveness of this voluntary approach should be subject to review by IOSCO within 24 months of adoption of an industry-wide code of conduct. If at that point it has become clear that self-regulation has not led to the required compliance of CRA with the code of conduct, an independent, external institution for enforcement should be considered. It must be clear that a formal enforcement mechanism does not lead to inappropriate bureaucratic structures or to undue costs for investors and issuers. Consequently, in UNICE`s view, there should be no formal enforcement mechanism at this point and, in line with CESR`s regulatory option 6, EU institutions and national regulators should restrict themselves to monitoring compliance with the code of conduct.

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