BUSINESSEUROPE

POSITION PAPER

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Credit Rating Agencies

PROPOSAL FOR A REGULATION

Introduction

BUSINESSEUROPE is in favour of smart regulation for financial services in response to the regulatory failures that led to the financial crisis and to address the risk of similar events occurring in the future. We therefore supported new legislation introducing a registration procedure for credit rating agencies which enhances competition.

Strengthened supervision and measures to reduce conflicts of interest have also improved rating processes, transparency and internal corporate governance of agencies and investors monitor ratings more closely. We agree that ratings should not be accepted as a substitute for own risk assessment as they form only a part of the due diligence undertaken by investors.

However, in our view, some of the new proposals for review of the rules for credit rating agencies, risk lowering the quality of ratings and increasing the costs for companies. The issues with ratings that surfaced at the beginning of the financial crisis were primarily concentrated in structured finance from the sub-prime segment. They did not spread across corporates, loans and project management as such. Overall, the market for corporate ratings is a functioning market from the perspective of investors and issuers alike even though the market is very concentrated and special attention should be given to increase competition to augment choice and reduce prices.

Rotation

Requiring issuers to rotate agencies after three years (or sometimes even one year), followed by a cooling-off period of 4 years, will harm the quality of ratings as knowledge will be lost. Taking into consideration the high concentration in the rating market (the three largest agencies have 95 % global market share) the requirement is impossible to be implemented in practice in the current market. There is no guarantee that new rating agencies will be able to meet the expectations for high-quality ratings. In any case, it will also not increase competition as each of the three large agencies will be certain that they will be solicited at some point in time.

Smaller rating agencies would also suffer if they cannot keep their clients for longer than three years and detailed regulation may in fact raise the barrier of entry for possible newcomers. In addition, smaller agencies do not always constitute an alternative as they are often specialised in particular companies or sectors. Rotation will also increase volatility in ratings harming investors who invest for longer than three years.

AV. DE CORTENBERGH 168
BE-1000 BRUSSELS
BELGIUM
VAT BE 863 418 279

BUSINESSEUROPE a.i.s.b.l

TEL +32(0)2 237 65 11
FAX +32(0)2 231 14 45
E-MAIL: MAIN@BUSINESSEUROPE.EU
WWW.BUSINESSEUROPE.EU

Disclosures

Requiring the disclosure of confidential information used to compile a rating for a structured product would increase costs and harm the quality of a rating when issuers could make less information available to the agency. Also, ratings are not exclusively prepared on the basis of ‘hard’ quantitative data but also on issues such as the quality of management or the competition position of a company. Reaching a judgement on this requires deep knowledge of the company concerned and constant dialogue between the rating agency and the issuer which is not possible in the case of unsolicited ratings.

Liability

We are concerned about changes to liability rules for agencies as this could significantly increase the costs of ratings and would also discourage entry by new players. A rating is a forward-looking assessment of relative credit risk and therefore, by its nature, a subjective opinion. It would therefore not be appropriate to make rating agencies liable for the rating as such. Liability requirement also seem to be in contradiction with the main goal of reducing reliance on ratings instead of own risk assessment. In this context it is unclear what the damage is to which the liability refers. It could also cause agencies to issue unduly cautious ratings which would increase the issuer’s financing costs.

ESMA

We have strong doubts whether the acceptability of rating methods should be decided by supervisory authorities. Proposals that would require rating agencies to obtain permission from the European Securities and Markets Authority (ESMA) to update their standards would slow down agencies’ response to new developments and could lead to a regulatory standardisation of rating methods. Rating agencies use different methodologies, for instance in describing default probabilities, and any attempt to standardise these would devalue the quality of the service provided by the agencies as a whole. The quality of rating methods should be decided by competition between methods on the rating market.

Issuer pays model

Changes to the issuer-pays model should not be imposed. Credit rating agencies operate on the basis of different business models; some agencies are paid by investors whilst the largest agencies operate on an issuer-pays model. The latter model enables ratings to have the large coverage that they currently have as they are publicly available. Rather than mandating a specific business model, agencies should be required to ensure that conflicts of interest are appropriately managed.

Sovereign ratings

A ban of sovereign ratings would increase investor uncertainty at a time when investors are most in need of independent information on credit risk. BUSINESSEUROPE is concerned that a prohibition on rating agencies to publish their assessment of the creditworthiness of sovereign issuers – whether temporary or permanently - would be perceived as a sign that there is something wrong with the possible result that investors are more likely to turn away from the European debt market. Preventing rating agencies from issuing 'outlooks' for sovereign issuers would force agencies to change rating more frequently and possibly unnecessarily making markets more volatile. As there is a close relationship between sovereign and corporate ratings this would also harm corporate issuers.

European Rating Agency

Regarding the creation of a European rating agency, we would like to stress that if such an agency is to be created, it should be independent both in reality and in the public perception. In addition, it is important that there will be no discrimination and that all agencies operate on a level playing field.