

EPFSF Briefing: Credit Rating Agencies

Summary: Credit Rating Agencies (CRAs) play a key role in European capital markets today, publishing opinions (“ratings”) on the creditworthiness of issuers/ issues of debt securities. Independent, objective and internationally consistent credit ratings raise the integrity, transparency and competitiveness of capital markets, lower the costs of capital for issuers and contribute to investor protection.

In recent years CRAs have attracted the attention of policy makers at national, European and international levels – given the important role their opinions play in capital markets and questions raised over their response to corporate scandals in the US and Europe, as well as over certain ratings decisions in Europe. In parallel, a greater regulatory reliance on ratings was introduced in the Basel II capital accord, and the Capital Requirements Directive (CRD).

The European Parliament and Council both requested the European Commission to review the role and activities of CRAs, and CESR was mandated to provide recommendations to the Commission. At the international level, IOSCO undertook a number of parallel initiatives.

As the result of these extensive reviews, a consensus emerged among stakeholders endorsing the provisions of the IOSCO Code of Conduct Fundamentals for CRAs (published in December 2004). Rather than establishing a rigid and intrusive regulatory framework which may be incompatible with the protection of the independence of CRA’s opinions, IOSCO recommended to implement the Code on a comply-or-explain basis, underpinned by a market-driven compliance mechanism and regulatory monitoring.

The Commission’s Communication on CRAs of January 2006 endorsed this approach, also referring to the relevant provisions of the Market Abuse Directive, the MiFID and the CRD already applicable to CRAs. The Commission asked CESR to monitor the implementation of the IOSCO Code. CESR is expected to publish its first report on this subject before end 2006.

Credit rating agencies (CRAs) provide opinions on the creditworthiness of issuers accessing public (and to a lesser extent) private debt markets. A credit rating is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system (AAA etc). Credit ratings are not recommendations to purchase or sell any security.

Credit ratings can be traced to the 19th century in the US, but they have gained global acceptance and recognition, especially in Europe since the early 1990’s, through the expanded role of capital markets in global financing (globalisation and disintermediation). In recent years, credit ratings have played a key role enabling new market instruments to develop (e.g. securitisation) and are systematically requested by professional investors as an important factor in determining credit risk.

Until the late 1970s, CRAs sold their research to investors through print publications. While CRAs today continue to publish significant levels of research, their business model has changed, with the bulk of revenues, at least for the largest international CRAs, now coming from fees paid by issuers which request a rating.

This “issuer-pays model” allows ratings to be disseminated free of charge to the whole market simultaneously instead of just to a privileged set of subscribers. It also reflects the desire of issuers to directly make their case to CRAs, but also the variable quality of public information in some jurisdictions, which strengthens the need for close interaction between the rating agency and the issuer. The inherent conflict of interest that such a relationship creates has been effectively managed by CRAs through a combination of measures, including a strict separation between their analytical

and business-related activities, and establishing a diversification of their issuer base – which are key for protecting a CRA's core asset, its reputation.

Competition between credit rating agencies

The credit rating business has often been described as “oligopolistic”, with frequent suggestions that market-driven or regulatory initiatives could make it more competitive. However, the necessity to build up reputation and investor recognition can only be achieved after a lengthy period of time which creates a challenge for newcomers, but does not prohibit *per se* small, innovative players to be successful in specific jurisdictions or asset classes.

Credit rating is a “labour intensive” business, which necessitates a critical mass of quality analysts and the development of complex methodology to cover international debt markets adequately and consistently. Also, the role of “benchmarking” provided by CRAs probably leads to some concentration, as investors will want to avoid an excessive number of available standards as long as the established players remain respected and credible.

However, competition on the market for credit risk analysis is fierce, and new players, often using integrated quantitative tools, models or innovative risk-assessment methodologies, provide strong incentives for established CRAs to continue to provide high quality analysis. Competition is critical as long it supports high-quality ratings.

Accuracy of credit ratings

The value of credit ratings relies on the analytical independence of ratings opinions, their international comparability and, as a consequence, the necessity to protect CRAs and their analysts from external influences. At the same time, CRAs have a duty of diligence in implementing their processes rigorously, in clearly communicating the rationale for rating decisions, whether general and related to ongoing adaptations of their methodology, or concerning a specific rating.

The track record or accuracy of credit ratings can be measured by looking at their performance over time. Matrices –generally published on a yearly basis and covering a lengthy (more than 15 years) period of time- measuring defaults per rating grade and transitions between rating grades show that higher rated bonds have a lower default probability than lower rated bonds, with a precise continuum between various rating positions and the observed occurrence of defaults over time.

Policy Initiatives on CRAs

Given the opinion-based nature of the rating business and the difficulty in distinguishing between the content of a rating and the process used to arrive at the rating, regulators have traditionally been wary of regulating CRAs.

In the early 2000s, the collapse of a few but visible corporations tied with accounting fraud both in the US and Europe (Enron, WorldCom and Parmalat) generated a widespread review of the role of the “market gatekeepers”, including CRAs. At the same time, particularly in Europe, the deterioration of credit quality affecting some prominent issuers, and the increased attention by CRAs on sensitive off-balance sheet commitments such as pensions, triggered questions about CRAs' accountability and the opportunity to submit them to a more extensive public oversight.

Regulatory attention was further increased as a result of the growing role of credit ratings in global capital markets, generated by private demand and also as a result of changes in legislation, such as the implementation of Basel II and the Capital Requirements Directive (CRD) in Europe.

In order to set a quality standard for external ratings to be used for the standardised approach, Basel II/CRD introduced a recognition system for ECAs¹. The principles on ECAI recognition in the CRD have been further elaborated by CEBS (the Committee of Banking Supervisors), culminating in the January 2006 “Guidelines on the recognition of ECAs”. CEBS performed an extensive “Joint Assessment Process” for the 3 largest international ECAs that are active in all 25 member states,

¹ ECAI stands for External Credit Assessment Institution, the Basel II/CRD term for credit rating agency.

which was concluded in August 2006². Competent authorities are expected to publish lists of ECAIs recognised in their jurisdictions before end 2006. While CEBS guidelines targeted traditional CRAs methodologies covering a large population of issuers, it is expected that several smaller players operating on a national or regional basis, may be approved by European banking supervisors for CRD implementation purposes.³

Besides this new banking regulatory framework, a review was initiated in parallel by securities supervisors at the international, European and national levels. At the international level, the G7 mandated IOSCO (International Organization of Securities Commissions) to assess the opportunity of establishing an international scheme for the regulation of CRAs. In Europe, the European Parliament, through an own-initiative Report⁴, adopted in February 2004, asked the European Commission to take a similar approach. In preparing its response to the Parliament, the Commission requested CESR to provide technical advice, which was published in April 2005. At the national level, different initiatives and reviews took place, including in Germany, where the Bundestag adopted a Resolution on CRAs in March 2004.

In the US, Congress adopted in a September 2006 a bill which reforms the NRSRO designation, which, since 1975, granted the Securities and Exchange Commission (SEC) the authority to recognize Nationally Recognized Statistical Rating Organizations (NRSRO). The NRSRO concept defines those CRAs whose ratings can be used by broker-dealers for capital adequacy purposes under the “net capital rule”. In order to establish a clearer and more objective process, the new Congress bill reforms the NRSRO recognition scheme, and CRA applying for NRSRO status now has to register with the SEC.

Beyond the specificities of the US situation, the release of the IOSCO “Code of Conduct Fundamentals” in December 2004 and the CESR advice in April 2005 have set the stage for an emerging consensus among market participants, regulators and CRAs around a possible market-driven oversight framework for CRAs. In this perspective, CRAs would develop their own proprietary code of conduct aligned on a “comply or explain” basis with the key provisions developed by IOSCO, and covering key issues as the integrity of the rating process, the individual behaviour of ratings personnel and communication between CRAs, issuers and the market around rating decisions.

The international character of policy discussions on CRAs is further emphasised by the fact that CRAs have continuously featured on the agenda of the EU-US Financial Markets Regulatory Dialogue both at Commission-US authorities and at CESR-SEC levels.

The European Commission’s Communication on Credit Rating Agencies, published in January 2006, reflected this consensus, arguing that existing financial services Directives applicable to CRAs (Market Abuse, CRD and MiFID) – combined with a comply-or-explain approach by the CRAs on the basis of the IOSCO code provided the most appropriate way forward in this area. CESR has been tasked with the role of monitoring CRAs’ compliance with the IOSCO code. Currently, CESR is finalizing a report to the Commission on this topic, which is expected to be released before year-end, and will cover the four international CRAs which have agreed a voluntary oversight framework with CESR.⁵ Through these various policy initiatives, where Europe has demonstrated a strong but pragmatic leadership, CRAs are now flexibly but firmly incorporated into the financial market regulatory landscape.

² See <http://www.c-eps.org/press/presslatest.htm> and <http://www.c-eps.org/standards.htm>

³ In a study in 2000, the Basel Committee identified 130 credit rating agencies worldwide.

⁴ Resolution 2003/2081(INI), Rapporteur was George Katiforis (PSE).

⁵ See <http://www.cesr-eu.org/index.php?page=groups&mac=0&id=43>

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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