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ICMA

ASSET MANAGEMENT AND INVESTORS COUNCIL

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January 6, 2011

Sent by email

Dear Mr Fridrich,

Public Consultation on Credit Rating Agencies

The ICMA Asset Management and Investors Council ("AMIC" or "the Council") was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the European Commission Public Consultation on Credit Rating Agencies. The AMIC has been very interested and engaged in the issue of the use of ratings produced by the agencies. The Council is presenting general comments on each of the six themes identified by the EC Consultation Paper.

General Comments

Overreliance on External Credit Ratings

1. The consultation paper points out to concerns that financial institutions and institutional investors may be relying too much on external ratings and do not carry out sufficient internal credit risk assessments. This overreliance can be explained by the fact that ratings have been increasingly woven into European and national laws, regulation and private contracts as highlighted by the European Commission. As legal requirements for ratings have proliferated, rating agencies have evolved in effect from information providers to purveyors of 'regulatory licenses'.

2. Most institutional investors do not rely exclusively on ratings. While it is true that credit ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions. Liquidity risk, for instance, is becoming a more important part of investment decision making – a risk not covered by ratings and assessments conducted by credit rating agencies. However institutional investors do vary in the amount of time and money they can afford to spend on the analysis of credit and liquidity risks. Accordingly they have mixed views regarding the timeline according to which references to credit ratings should be removed from regulations.

3. The AMIC is of the view that reforms, while desirable, need to be well conceived in order to maintain the public-good aspects of credit ratings and to avoid unintended consequences such as increased costs and reduced access to capital markets. The current regulatory framework is so reliant on ratings that significant changes can only be conceived to take place over time. Mandates to use ratings have become part of the fabric of financial markets, and cannot be unwoven instantaneously.

4. The Prospectus Directive has two relevant requirements in this context – (i) the general requirement that prospectuses include all information necessary to investors and (ii) detailed requirements (as above), depending on the type of issue, for ratings information to be included. Deletion of the requirement in (ii) would not affect the obligation to include (and potential liability for omitting) ratings if they continue to be material to investors. A risk arises if it is believed that (ii) is the exhaustive embodiment of (i). This may result in trying to prohibit issuers from including ratings information thus potentially exposing them and their lead-managers to liability, which could affect EU issuance.

5. Many institutional investors are legally obliged to hold only securities of some minimum rating, or may have to hold larger reserves when investing in bonds of lower ratings. Ratings are also used in private contracts, for example to define the investment objectives of bond mutual funds. Accordingly the AMIC believes that regulatory use of ratings has exacerbated pro-cyclicality in the financial system as a whole. However, in order to reduce private reliance on ratings, credible alternatives or substitutes should be developed, particularly for institutions that lack resources to assess independently the huge number of available fixed income instruments. The AMIC believes that it is perfectly rational for individual firms and institutional investors to be guided by a rating when making their investment decisions, as long as the quality and integrity of ratings is kept. Therefore the AMIC welcomes the idea that the paper is focusing on the evaluation of different approaches to assess risk for regulatory purposes.

6. Credit rating agencies provide an assessment of the creditworthiness of a corporation or security, based on the issuer's quality of assets, existing liabilities, borrowing history, and overall business performance. Investors depend on the ratings to predict the likelihood of default on financial obligations and the expected repayment in the event of default. As corporations require more capital and issue debt paper among the broader, anonymous public, standardised information about the creditworthiness of issuers investors do not know themselves or with whom they do not have a personal relationship needs to be made available. Credit rating agencies offer the issuing company the opportunity to use and communicate non-public information externally, without

disclosing its precise content. This is a critical aspect of a functioning international capital market. Credit rating agencies aggregate information about the credit quality of various types of borrowers and their financial obligations; allowing such borrowers access to global and domestic markets, and to attract investment funds.

7. For the individual investor who does not have the capacity or time to investigate, monitor and evaluate the quality of available financial instruments, credit ratings provide simple, easy to use information that can be used as part of the investment decision-making process. Knowing the relative risk attached to different financial instruments allows investors to better and more easily adjust the global risk profile of their investment portfolios to their own investment preferences. However, credit ratings are also useful for professional portfolio managers, as they can serve as the basis for contractual agreements with clients that in advance specify criteria for investment decisions.

8. It is also worth noting that while the ratings of structured products have been widely criticised, corporate ratings have held up much better during the recent crisis. This means that for firms issuing fixed income securities, ratings are still an important component of capital markets.

9. It has been often suggested that market-based risk assessment tools such as credit spreads could be used more often in the analysis of the credit worthiness of an issuer. However credit spreads incorporate credit risk, market liquidity, and market psychology in a mix that is difficult to disentangle.

10. The Consultation Paper suggests other alternatives to the reliance on ratings of credit rating agencies. The AMIC response will review the different proposals.

Sovereign Debt Rating

11. The AMIC believes that there is no easily available solution to improve the vexed issue of sovereign debt rating, notably in respect of the political implications of ratings. The AMIC recognises that micro-economic and macro-economic factors need to be taken into consideration to provide a reliable rating. However information on sovereign debt is abundant and it is hard to see whether agencies have informational advantage in this context.

12. Moreover though the rating agencies are supposed to evaluate the states' capacity to obtain credits on an impartial and objective basis, there are several indications that their vision could be biased by several elements.

13. The dominating rating agencies are all based in the USA. Their origins are deeply rooted within the American market logic. They may pay less attention to the very specific and unique characteristics of the EU market, imposing the American analysis blueprints. The results proved to be at least doubtful in the last years, but the agencies fail to change their approach. Greece's gaping public debt was discovered in October, but the downgrading was operated severely only at the end of December 2009.

Enhancing Competition in the Credit Rating Industry

14. The consultation paper suggests that promoting competition among rating agencies could improve the quality of ratings. But reforms aimed at doing so are complicated by the fact that size and market recognition may be higher barriers to entry than regulatory status, turning the credit rating industry into an oligopoly. In fact there are already many smaller players in the industry, most of which have the same standing for regulatory purposes as the major rating agencies but have failed to gain market acceptance and thus remain limited to geographic or product niches. An entry into the credit rating market is only possible in geographical or sector-specific niches. A natural hurdle for more competition is that issuers commission primarily those agencies that are held in high esteem by investors; however, this, in turn, is significantly determined by the track record of the agency. New entrants, who obviously cannot present any historical figures, tend to indicate a lack of reputation that, in turn, represents a large competitive disadvantage. It may also imply the duplication of work between agencies and end up being a more expensive business model for new entrants.

15. Creating a state credit rating agency begs the question of liability of those ratings. Facilitating market entry by offering political support for a European credit agency, for instance, would do little to boost quality through competition as explained below. Moreover the proposal seems to entail a shift of conflicts of interest from issuers to regulators.

16. The quality of the rating is also perceived differently depending on who is reading the rating. To an issuer, the best rating is an AAA rating. To an investor who holds a bond, it will be a rating that is never reduced. To potential buyers of the bond, it is a rating that accurately reflects default probabilities and that is comparable across issuers and industries.

17. Competition in credit ratings may force rating agencies to favour issuers. This is contrary to the interest of those who rely on ratings to make investment decisions or to regulate. Indeed a strategy of increasing competition might actually lower the quality of ratings. The reason is that new entrants in an issuer-pays system would probably compete by offering higher ratings or by lowering prices and thus reducing both the level of effort in ratings and their reliability. Moreover, there may be a benefit to having a limited number of global credit rating agencies: it promotes greater consistency and uniformity in ratings across markets, making it easier for investors to compare debt securities issued by different countries.

18. Although there are potential advantages to competition unrelated to falling ratings quality. For example, having more rating agencies gives the authorities more leeway to ban or punish a rating agency, because it can be done without debilitating the financial markets.

19. Rating agencies could be required to disclose their fees. Rating agencies currently disclose only summary information regarding fees, and they do not make data available for fees on individual deals. Fee transparency would increase incentives for ratings accuracy by creating a new method of competition in the ratings business. Ratings 'shopping' based on gee levels would not present the same conflicts and challenges as ratings shopping on rating levels. Moreover, such disclosure could also reveal potential conflicts of

interest arising from an issuer's heavy use of one particular agency.

20. The AMIC believes that there is some value in having in-house credit analysis functions. However the Council recognises that this possibility is only offered to the bigger players in the market, and those smaller investors may be at a disadvantage. Making the distinction and the degree of sophistication is therefore key to ensure the functioning of the asset management industry.

Civil Liability of Credit Rating Agencies

21. The AMIC believes that difficulties will be encountered when seeking a basis for liability for an erroneous rating, as the tender of a rating grade does not constitute a pure statement of fact. Rather, a prognosis on the future ability and willingness of a debtor to pay will be set out. Ratings are expression of opinion which cannot be categorised ex ante as 'right' or 'wrong'. In fact credit rating agencies refer to this in their disclaimers in order to delimit the recipients' expectation right from the very beginning. It is understood that creating rating agencies do not incur any liability for the mere fact that the prognosis does not turn out to be true. However liability of the rating agency can indeed be considered when it, contrary to its obligations, bases its rating on unfounded or incomplete data sources or does not carry out prognosis properly.

22. However even if the large credit rating agencies emphasise that they do not assume any responsibility for the correctness of their prognoses, do not make any recommendations and, in particular, do not hold any expert status, they still describe their product as one that was compiled objectively, neutrally and on an academic basis. Credit rating agencies present themselves as bodies with particular expert knowledge, which, owing to their quality and neutrality, enjoy great confidence with the investor public. The CRAs are also reliant on this image of they are to satisfy their role as an information intermediary.

23. One of the main concerns, as was already highlighted in the IOSCO Code, is the assurance of quality and integrity in the rating process, so that the credit rating agencies can fulfil their task of dissolving information asymmetry on the market. A methodical and transparent procedure of compiling the rating product has an important role in ensuring consistent quality and integrity of ratings. Each prognosis can only be as good as the data upon which it is based. The assurance of the quality of a rating also requires that the agencies satisfy high professional standards in the training and further education of their personnel.

Potential conflicts of interest due to the 'issuer-pays' model

24. The paper suggests that the issuer-pays business model inherently creates conflicts of interest. The "issuer-pays" model has the obvious risk of generating pressure to be friendly towards issuers, especially issuers that generate a lot of ratings business (e.g. they have a lot of outstanding debt and issue many bonds). 'An investor-pays' model in which rating agencies would earn fees from users of the rating information is being discussed in the paper. Such a change, while dramatic, would not be unprecedented. The major rating agencies relied on subscription fees as their primary source of revenue for most of their history until the early 1980s. In fact, a few rating agencies with NRSRO designation in the United States currently operate on an investor-pays model, but they remain small.

25. To the extent that the collective failures of rating agencies have been due to compromised objectivity, the investor-pays approach could be conceived as a possible solution. However the AMIC believes that it would be difficult to implement without adverse consequences. For example, investors are unlikely to be willing to pay the substantial subscription fees necessary to generate a comparable revenue stream. As a result, an investor-pays model would probably result in substantially fewer offerings receiving ratings, to the detriment of smaller issuers and less liquid issues. Moreover it is suggested that it would not eliminate conflicts of interest but instead shift them from issuers to investors.

26. Historically, rating agencies tended to be financed mainly by investors (the "investor-pays" model). This model is used currently by a few of the smaller rating agencies, but it has two main drawbacks. First, it relies heavily on the ability to enforce property rights to information that is very easy to spread. Second, it precludes wide sharing of the ratings—if they are made public for free, why would investors pay for them?—and this means regulation and legislation relying on ratings becomes much harder to implement.

27. Another type of model which proposed is the 'payment-upon-results' model. Some fixed fee is charged for bond issuance and used to finance ratings. Issuers have no choice but to pay the fee, and are not allowed to choose the rating agency. By severing the link between issuer and payment, this is supposed to limit potential pressure for favourable ratings. This model has not really been tested, and is probably difficult to implement. The largest issue is how to assign ratings tasks to firms.

In brief, the AMIC believes that credit rating agencies have ventured far from their original role as reliable financial gatekeepers. They have unfortunately failed to provide consistently dependable information about credit risk. However it is worth recognising that the problems were worse regarding the ratings of structured finance products. Moreover many institutional investors are still required to use ratings, regardless of the accuracy of the ratings.

Alternatives to credit ratings agencies are difficult to identify. Alternatives are emerging but may be out of reach for some investors for some time. Ultimately, as institutional investors become more comfortable with alternative sources of credit information, competitive pressure could spur credit rating agencies to improve their performance and accountability.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

Robert Parker
AMIC Chairman