CREDIT RATING AGENCIES (CRA III)

27 February 2012

Position

Context

The European Regulation of September 2009 on credit rating agencies ("agencies"), which came into force in December 2010, requires in particular the registration of agencies, reinforces their governance and prescribes publication of rating methodologies. A first amendment of the Regulation, in May 2011, organises the approval and supervision of agencies by the European Securities and Markets Authority (ESMA), and assigns to it exclusive powers of supervision and investigation and power to impose penalties for non-application of the Regulation.

In 2011, the European institutions and the G20 conducted thinking which was organised around the following five themes: 1. the extent of the use of ratings and the sometimes excessive reference to ratings in legislation; 2. sovereign debt ratings; 3. competition; 4. the civil liability of agencies; 5. conflicts of interest and the issuer-pays model. Reference to ratings will be dealt with by the revision of the texts concerned. All the other topics, however, will be dealt with shortly in a second amendment of the Regulation. In this context, the EC published in mid-November 2011 legislative proposals designed to impose restrictions on the influence and powers of agencies and having as their main objectives: deconcentration of the market; strengthening of rules concerning the independence of agencies; increased comparability of ratings; quality of agency processes and methodologies and reinforcement of the ESMA's supervisory powers. The possible effects for companies are linked to three series of elements:

– ESMA's approval of new rating methodologies, harmonisation of rating scales and the establishment of a European Rating Index by ESMA;
– constraints imposed on the choice of agencies and publications:
    - for solicited ratings of instruments other than sovereign debts, introduction of a mandatory rotation of agencies – after 10 ratings (and more than one year) or every three years – ; prohibition of rating of an issuer, at his request, for a period longer than three years (six years in both cases for one of the agencies in the event of voluntary or compulsory use of more than one agency); introduction of a 4-year cooling-off period;
    - disclosure on agencies' websites, on an ongoing basis, of the information which is submitted to them for their initial reviews and for their preliminary ratings (whether or not issuers contract with the agency).
– at European level introduction of a system of civil liability of agencies towards investors, for infringements of the Regulation, either intentionally or with gross negligence, having an impact on a rating and causing damage to an investor who has relied on it (when purchasing a rated instrument). Under the EC proposals, where an investor establishes facts from which it may be inferred that a credit rating agency has committed any infringements listed in the Regulation, it would be for the rating agency to prove it has not committed an infringement or that the infringement did not have an impact on the issued rating.

EuropeanIssuers

The issuer-pays model is not questioned at this stage, but, by December 2012, the EC will submit a report on this subject to the EP and the Council and will consider more far going solutions, taking into consideration the thinking in progress in other jurisdictions, including the United States.

Progress

The EC's proposals are now subject to examination by the European Parliament and the Council.

Position

The quality of credit ratings for corporate instruments has not been an issue in the crises. In this regard the proposed legislative proposals appear disproportionate for these instruments and are likely to affect the quality of ratings and their monitoring and updating over time.

The adoption of the proposals would eventually lead to higher risks for investors and to an increase in the cost of finance for European issuers, while these should be able to access to international funding in the best conditions, especially in the current economic context. Also any risk of breach of business secrecy or market abuse resulting from access to or disclosure of corporate information should be avoided.

The financing of public deficits and the strengthening of prudential rules for banks and insurance companies lead to a reduction of intermediate financing of European companies and, ultimately, the need for them to draw more frequently on international financial markets and investors, which are key players for their funding. While large companies regularly issue bonds, small and medium companies, which currently are funded mainly by banks, increasingly will have to turn to the markets for financing purposes and thus will depend on a rating.

This occurs in a context of international competition, where it is important that issuers and their bonds issues are visible and gain the confidence of international investors. At stake is the companies' ability to finance their investments and activities at the lowest available costs, the competitiveness of the European economy as a whole and the maintenance of economic activity.

We strongly support the objective set out in the European Commission proposal to reduce the reliance on ratings in banking and financial regulation. Also we regret the importance that ratings have sometimes. However it must be recognised that there currently is no practical alternative solution to enable companies to access international funding in the best conditions.

In this context, three elements are therefore needed:

- The international dimension: the solutions adopted in the European Union (EU) should not affect the perception by international investors of European companies compared to their competitors in third countries. Therefore, if weaknesses were identified in the current Regulation, the solutions should be sought and coordinated internationally, especially as the leading agencies are global players;

- The need to maintain the quality of ratings: the quality - actual or perceived - of ratings of European companies should not be impaired by changes in European regulation;
- The need not to penalize European companies' access to bond financing: it should be emphasized that the quality of ratings for conventional corporate bonds has not been an issue in the crises. In this regard the proposed measures for these debt instruments appear disproportionate and are likely to affect the quality and monitoring of credit ratings, leading eventually to an increase of the cost of bond financing in an already difficult context.

Companies have until now supported the strengthening of the regulation on credit rating agencies, in particular the rules adopted to improve the governance of agencies, the transparency of their methodologies and the monitoring of the quality of their processes.

However, companies oppose the following proposals:

1) mandatory rotation of agencies

Companies with international reach need credit rating and generally use one or two of the major agencies, as international investors usually take into account their ratings as a basis for their own analysis and as a trustworthy signal of the issuers' creditworthiness. The rotation rules proposed would systematically lead to not being able to use these agencies, after a certain period of time, and having to replace them with agencies that do not have sufficient presence and are not recognised internationally, or have not demonstrated their capability of issuing high quality ratings.

As agencies are responsible for monitoring and updating any previous ratings over the life of the bonds issued, mandatory rotation would also lead to discontinue their ratings or to promote the development of unsolicited ratings. Most of the knowledge and experience of the company would be lost regularly, forcing incoming agencies to invest more resources and follow a learning curve (over 2 or 3 years for international companies).

This would have serious implications for companies and investors:

- discontinuation and lower quality of ratings, resulting in higher risks for investors;
- risk of companies losing access to international financial markets, in the absence of credible agencies or ratings;
- significant increase in companies' cost of finance, as well as higher rating costs.

2) approval of new rating methodologies

Changes in methodologies may have important consequences on ratings and on the contractual terms that refer to ratings / "rating triggers". They may also be confusing for investors and issuers, especially if they are introduced without prior dialogue and explanations or without transition. Therefore, changes in methodologies should be subject to a rigorous process, including public consultation and feedback, to a justification of the final outcome and, save in exceptional circumstances, to a transitional period.

However, approval of changes by ESMA would lead to differences between the methodologies used internationally and those used in the EU and could affect the perception by international investors of the credit ratings provided to European issuers.

Overall there is a need for transparent and robust assessment criteria and methodologies and for competent and independent rating committee members.

3) requirement on agencies to publicly disclose information submitted to them

The obligation to disclose on the websites of agencies, on an ongoing basis, information submitted to them for their initial reviews or for their preliminary ratings would be problematic in several respects:

- It would entail a risk of breach of business secrecy, resulting in particular from publishing elements relevant to the company financial strategy or management decisions (assessment of the opportunity and features of an issue);
- It might limit the sharing of information with agencies, which would reduce the quality of ratings and eventually the ability of companies to access finance at lower cost;
- It could be incompatible with existing data-protection laws.

In contrast, we strongly support a clear distinction between "solicited ratings" and "unsolicited ratings".

4) possibility of a change in the compensation model of rating agencies for conventional instruments

Given the rules, information and control-mechanisms already in place, companies remain opposed to the removal of the issuer-pays model for non-structured instruments and underline the risks associated with payment by investors:

- Conflicts of interest (it being possible for the investor to initially have a vested interest in obtaining a low rating and / or subsequently, no downgrade of the rating obtained);
- Risk of breach of business secrecy or even market abuse, if any agency or buy-side analyst had access to company information;
- Risk of reduced quality ratings;
- Absence of broad communication to the public (other investors and stakeholders) and "free-rider problem" (as many investors would benefit from a rating solicited by a single investor, the search for an investor willing to pay for a rating could be problematic);
- Reduction in the number of bondholders and overall increase in costs.

In any case, maintaining the issuer-pays model does not prevent investors from using rating agencies to contribute to their own credit assessments.

5) the proposed system of civil liability of rating agencies

The issue of the civil liability of rating agencies should be handled under Member States' civil liability regimes, and not under a European regime of civil liability. The competence of the European Union to set rules in the field of civil liability is disputable with regard to the Treaty on the Functioning of the European Union. In addition a European regime could not be applied consistently across jurisdictions and would prove unworkable, e.g. as regards the assessment of faults/infringements of the Regulation, damage and causal link between fault and damage. Rather, it seems adequate to reinforce Member states responsibility for enforcing existing civil liability regimes.

Given the adverse effects they would have on the quality and cost of ratings, the following proposals would be particularly inappropriate and should also be removed:

- the allocation of the burden of proof to the rating agency would entail an increase in the disputes rating agencies would have to handle. This would result in overly conservative ratings and higher costs for issuers. It would increase entry barriers in the rating market and threaten existing agencies;
- referring to damage in the only case of purchase of a rated instrument might artificially lead agencies to be overly conservative in their ratings as well. Companies consider that an investor holding a rated instrument may also incur damage if an inadequate rating led him to sell it. It is more relevant to refer to "a transaction in a rated instrument" than to the purchase of a rated instrument.

It should also be clarified in the Regulation that the credit rating agency assumes the responsibility of adopting all necessary measures so that the information it uses in assigning credit ratings is of sufficient quality and from reliable sources

6) <u>the treatment of securitised corporate loans or trade receivables</u>

For risk diversification and liquidity management purposes, some corporates securitise loans, especially trade receivables. These corporate asset backed securities, which are qualified as structured finance products, do not however pose a risk for the financial system. For instance, since 2007, the cumulative losses concerning the structured finance products based on US sub-prime mortgages represented almost 20 per cent, vs. nearly zero per cent (0,35 per cent) for the losses on securitised loans by German corporates in the automotive sector.

The proposed obligation on the issuer to disclose information on structured finance instruments would thus be overly costly and redundant, as rating agencies are already required to make public information they receive from the issuer of such instruments. Also the use of a second rating should not be required. It should be left to the judgment of the issuer, based on its own assessment of investors' expectations.

__EuropeanIssuers__ was set up to represent the interests of publicly traded companies in Europe, which are subject to complex rules on issues such as shareholder rights, corporate governance and reporting and market regulations. We seek well functioning European financial markets which serve the interests of their users, as well as good corporate governance and responsible share ownership. More information can be found at www.europeanissuers.eu