Jonathan Pitkanen
Head of Investment Grade Research

Credit Rating Agencies: regulatory reform in Europe

Proposals of the European Commission

On the 15th of November 2011 the European Commission (EC) announced further proposals concerning the regulation of Credit Ratings Agencies (CRAs) – the third CRA reform since the financial crisis. The intention is to 'reduce risks to financial stability and restore the confidence of investors and other market participants in financial markets and ratings quality'. While Threadneedle fully supports the aims of the EC, were the proposals to be implemented in their current form, not only are these goals unlikely to be achieved, but their impact would be materially negative to credit markets. To redress the over-reliance on credit agencies, the EC is seeking to reduce their influence.

In this Viewpoint we look at some of the key proposals and assess their likely impact on the market.

A rotation of CRAs every three years is proposed, with a four year 'cooling off' period, or every year if they make more than ten consecutive ratings on the same issuance. If a company has two ratings, one can be retained for six years. Under the proposals, CRAs must review sovereign ratings every six months and justify any rating action.

Most issuers have more than one rating and under this proposal it is the issuer who will choose which agency to keep. It seems probable that the issuer will keep the agency which rates it more favourably which distorts the market, encouraging higher ratings and reducing independence. That CRAs will not be able to rate more than 10 issues of an issuer is concerning. For heavy issuers such as financial services companies, there will be frequent changes in CRAs, ultimately resulting in newly established CRAs being the only ones allowed to rate a new issue. The requirement to justify rating actions is likely to lead to less timely actions as CRAs and their analysts will be reticent to downgrade issuers, particularly sovereign ones. This is exacerbated by CRAs now becoming liable for rating 'accuracy'.

CRAs will be liable for the quality of their ratings, with investors able to sue CRAs (in national courts) for failure to respect obligations set out in the European CRA regulations. The onus will be on the CRA to prove it was not negligent.

It is generally thought that certain European jurisdictions are less friendly to financial market participants than others. CRAs may be more reticent to provide ratings in jurisdictions that are perceived to be more aggressive towards them. A lack of ratings will not improve investor confidence in struggling European Union nations. Moreover, the threat of litigation may actually serve to increase reliance on ratings due to investors believing that the threat of litigation will act as a guarantee of rating quality. This proposal is anti-competitive as it will deter new CRAs from entering the market.

> ***"The impact of the EC proposals would be materially negative to credit markets."***

Harmonisation of rating scales. CRAs will require regulatory approval from the European Securities and Markets Authority (ESMA) before amending methodologies.

Any change in methodology will be slowed due to ESMA's role, which could expose CRAs to litigation risk when they believe a new methodology is required to reflect the risk of an issuer accurately. Until ESMA approval is received, the published rating will not accurately reflect their current views, and will therefore potentially be liable for ‘inaccuracy’. With ESMA approval required for amendments or new methodologies, the independence of future ratings must be questioned. If ESMA seeks to amend new methodologies or disallow amendments to existing ones, this is expected to lead to a convergence of ratings from the CRAs. This is the opposite of what the investment community requires. Independent, original opinions will better serve investors than having to pick from a cohort of identical ratings under one methodology, which increases systemic risk. Reliance on ratings will increase rather than decrease as less sophisticated investors consider the ESMA approval of a methodology to be an official ‘guarantee’. CRA methodologies will no longer be global, thus acting as a substantial impediment to investors making global relative valuation decisions.

The EC will assess the quality of CRA regulation in other jurisdictions. If it doesn’t meet the EC standard, ratings assigned in these jurisdictions may not be recognised.

The US will be the key ‘other’ jurisdiction. Regulators outside of the EU will have to demonstrate similar regulations to gain ‘equivalence’. In order to avoid CRAs rating outside of the EU, the EC is proposing that equivalence is only to be granted to regimes with similar criteria. However, similar regimes do not currently exist. This might mean that ratings produced by the US offices of CRAs are not ‘valid’. These would include the majority of global ratings. One implication may be that EC regulators require any such ratings to be considered ‘unrated’ and therefore subject to materially greater capital requirements.

Proposals of the European Parliament

Separately, the European Parliament has suggested aggressive amendments. On the 15th of February 2012 the European Parliament’s Committee on Economic and Monetary affairs published proposed amendments which are likely to have additional negative impacts on fixed income products, financial markets and the economy as a whole.
The European Parliament’s draft proposals include:

- Limiting CRAs to rating only 25% of an asset class. This will mean less of the universe will be rated or there will be more CRAs of lesser quality.
- The European Parliament is proposing a ban on unsolicited sovereign ratings. This is likely to result in a substantial reduction in the number of rated sovereigns as sovereigns are expected to refuse to renew contracts with CRAs following downgrades. A ban on sovereign rating outlooks results in reduced information to the market and therefore less transparency. With the withdrawal of sovereign ratings, the definition of ‘risk free’ will contract even more. Investors may well reduce EU-sovereign debt for the ‘risk free’ debt of transparent, multinational, non-EU corporates, and sovereigns.
- Establishing a public, independent European Rating Agency. Such an agency is likely to attract major credibility concerns, particularly in the early years.
- CRAs will no longer be allowed to produce ‘opinions’ but instead will be providing an ‘information service’. Threadneedle, similar to other larger asset managers, only uses CRA ratings to support the primary analysis carried out internally. We have always considered, and will continue to consider, the ratings of CRAs as opinions. We cannot see any benefit in the amendment of the definition.

Summary

In summary, the goals of diminishing risk to financial stability, enhancing transparency and improving competition are unlikely to be achieved through implementation of these proposals. European ratings will become more uniform, dictated by the authorities, while comparability with non-EU rated transactions will be lost, paradoxically leading them to have greater credibility and investor appetite. Within Europe, CRAs are likely to rate higher in jurisdictions where there is more legal certainty and lower in those where there is less credibility. It is likely that ratings are not just downgraded but retracted from issuers in the European periphery. Ratings will have greater potential to confuse. The result is that the credibility of CRAs will be lowered, with a significant proportion of the investor community needing to carry out more research for themselves for the first time, and being ill-equipped to do so.

More publicly available information will result in more resources being required to analyse it. European debt will require a higher risk premium as confidence in the credibility of ratings declines compared to ratings issued outside of the EU. With increased volatility and the reduced number of ratings per issuer, the value of ratings may diminish to such an extent that they offer no value within investment mandates.

Shorter-term debt issuance is likely to increase. With ratings from the established rating agencies requiring rotation every three years, longer-dated debt will become less attractive as new, inexperienced CRAs would be rating a greater proportion of it. Due to the litigation risk, smaller entities and entities in aggressive jurisdictions will either not be rated by the CRAs, or rated lower than anticipated to cover off this potential risk.

Ratings provided by non-EU CRA offices will maintain credibility, with EU investors potentially re-focusing investments in markets such as North American or emerging markets. This will result in EU issuers paying more to borrow, at a time when the EU economy remains fragile. Smaller asset managers may be unable to invest sufficient resources in analysing issuers, with industry consolidation a possible consequence. National regulators may require greater in-house analytical capabilities from investors if the number, the volatility and the perceived quality of ratings were to deteriorate.