

## GUIDES FOR CREDIT RATING AGENCIES

### **Draft rules governing the conduct of credit rating agencies were issued recently by the international securities body IOSCO. Corporate treasurers' associations from the UK, US and France have jointly responded to these proposals.**

In September 2003, the International Organisation of Securities Commissions (IOSCO) issued a Statement of Principles (SoP) governing the work of credit rating agencies (CRAs). The SoP provided a series of "high-level objectives" for CRAs, regulators, issuers and others to protect "the integrity and analytical independence" of the credit rating process. The SoP said that CRAs should seek to issue opinions that "help reduce the asymmetry of information that exists" between corporate borrowers and lenders. The SoP, in particular, seeks to address:

- Low-quality ratings analysis.
- Analytical processes of questionable integrity.
- Stale, misleading ratings that fail to reflect changing circumstances.
- Internal and external conflicts of interest that impinge on independence.

In October 2004, IOSCO followed up the SoP with a consultation paper on a draft, *Code of Conduct Fundamentals for Credit Rating Agencies*. This paper suggested a number of measures that, it said, ought to be adopted by ratings agencies, a few of which are:

- The CRA should have and enforce written procedures to ensure its opinions are based on a thorough analysis of all relevant information available to it.

- It should use methodologies that are rigorous and systematic. Where possible, the ratings should be able to be subjected to objective validation.

- The CRA should regularly review the issuer's creditworthiness and initiate a review of a rating upon receipt of any information that might reasonably be expected to result in a "rating action".

- The CRA and its analysts should use care and professional judgement to maintain independence and objectivity.

- The CRA should not take (or refrain from taking) a rating action based on the potential impact of that action on an issuer, on investors or on other market participants.

- The CRA should adopt written internal procedures to identify and then eliminate – or manage and disclose – actual or potential conflicts of interests.

- If a CRA receives payment from a rated entity for services other than its rating service, the CRA should disclose the proportion of such non-rating fees.

- Analysts should not be involved in discussions relating to fees with any entity they rate.

- The CRA should publish information about its procedures and assumptions so that outsiders can understand how a rating was arrived at.

- When issuing a rating, CRAs should explain in their press releases and reports the key elements behind the decision.

- The CRA should alert the issuer prior to issuing or revising a rating and give the issuer an opportunity to comment on any factual errors or other matters.

- The CRA should have mechanisms to protect confidential information given to it by an issuer.

- If a CRA becomes aware of non-public information that, under applicable laws and regulations, ought to be disclosed by the issuer, the CRA may be required to disclose such information itself. However, it should permit the issuer to immediately disclose this information itself.

### **Treasurers' response**

The UK Association of Corporate Treasurers, the American Association for Financial Professionals and the French Association Française des Trésoriers d'Enterprise issued a joint response to the IOSCO draft Code of Conduct Fundamentals.

While broadly welcoming the proposals, the treasury associations oppose what they regard as the "policing" role by which CRAs are expected to published disclosable unpublished information about an issuer (the last bullet point in the list above).

While issuers should abide by disclosure rules, the treasury associations believe that IOSCO's proposal "would totally change the relationship of trust needed for issuers to make full and proper disclosure to CRAs".

Moreover, they argue that, in jurisdictions where securities laws don't provide for the disclosure of price-sensitive information to CRAs, regulators should make provision for this along the lines of the "carve-out" for CRAs in US Regulation FD so that disclosure of information to CRAs under contractual confidentiality does not automatically require disclosure to the market.

The treasury associations also believe it is unreasonable to expect a CRA to base their ratings on *all* available information; they suggest instead that a CRA's

rating should be based on "consistent processes".

IOSCO issued a number of proposals governing connections between a CRA and its analysts on the one hand and any commercial, family or relationship links with the rated entity; for example, no CRA employee should be involved in rating a company if that employee's spouse currently works for the rated entity. The treasury associations suggest that such rules be extended to include similar connections with a *direct competitor, supplier or customer* of the rated entity.

While IOSCO says that CRAs should disclose whether an issuer has "participated in the rating process" by giving access to top management and confidential information, the CRA should only publish a rating on that basis if it has no reason to believe that information normally disclosable in such a relationship has been withheld or may be doubtful.

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A wide range of Briefings can be found at [www.financialdirector.co.uk/briefing](http://www.financialdirector.co.uk/briefing)

### **Useful links**

- The IOSCO proposals are available at [www.iosco.org](http://www.iosco.org)

- The response by the ACT and its US and French counterparts – along with an article detailing what information ought to be given to a ratings agency – is available at [www.treasurers.org](http://www.treasurers.org)