Date: February 2nd, 2012

To
House of Commons
Treasury Committee

Via treascom@parliament.uk.

Reference: Inquiry into Credit Rating Agencies dated December 16th, 2011

Honourable Member of Parliament,

With reference to your inquiry into Credit Rating Agencies dated December 16th, 2011, kindly find attached the response of our associations.

We thank you for requesting this feed-back from our side and remain at your full disposal if you wish to clarify any point stated.

Yours sincerely

Thomas Missong
EACRA President

Thomas Morgenstern
EACRA Secretary General

About EACRA

The European Association of Credit Rating Agencies ("EACRA"), registered in Paris, was established in November 2009. The Members of the Association currently originate from 8 European countries and include the following companies:

- **Assekurata Assekuranz Rating-Agentur** is the first independent German rating agency that has specialized on the quality evaluation of insurance companies
- **Axesor**: Leading independent provider of information and marketing services in Spain. Provides comprehensive information and an indication of solvency on all registered Spanish companies.
- **BCRA** assigns credit ratings to the leading Bulgarian insurance and pension companies, banks, corporates, municipalities
- **Cerved Group**: Italian Credit Rating Agency recognized ECAI by Bank of Italy
- **Credit Rating**: covers corporate, financial institutions and municipalities in Ukraine
- **CRIF**: First Italian company to be registered as Credit Rating Agency in the EU, providing evaluations on the creditworthiness of SME's and large Italian companies.
- **Informa D&B** is the Marketing, Financial and Business Information leading company in Spain, offering currently more than 3.7 million online ratings on Spanish companies

- **Informa D&B** is the Marketing, Financial and Business Information leading company in Portugal, offering currently more than 820K online ratings on Portuguese companies
- **JCR Eurasia:** is Japan Credit Rating affiliated company in Turkey and covers all market segments.
- **National Rating Agency** (NRA) is one of the leading independent rating agencies in Russia. As of today National Rating Agency has assigned ratings to over 750 leading Russian and international companies.
- **PSR RATING**, based in Germany, focuses on solicited corporate ratings and the development of valid rating systems
- **RusRating** is a credit rating agency based in Moscow, with sister agencies in Armenia and Kazakhstan. It is accredited with the Ministry of Finance of the Russian Federation.

The Members of the Association have very different business models while assigning ratings. All are deeply rooted in their respective markets; enjoy a high market share and a good reputation with local investors

Submission to the Treasury Parliamentary Committee from the European Association of Credit Rating Agencies (EACRA)

Introduction

1. EACRA is an association of predominantly small credit rating agencies operating in Europe. The global market for credit ratings has been dominated by three credit rating agencies (S&P, Moody's and FitchRatings). Smaller credit rating agencies have become established and have been able to compete by providing high quality services in specialised fields or within distinct national boundaries. EACRA agrees with many observers that problems in the credit rating market, including the genesis of the global financial crisis starting in 2007, have arisen due to over reliance on just three sources of rating information.
2. EACRA is concerned that reactions to the behavior of dominant companies in the industry may lead to the undermining of the economics of the entire industry, and thereby will diminish the very real advantages credit ratings bring to a mature financial market. Rather than destroy the credit rating industry, EACRA seeks to support reforms that will lead to a greater diversity of credit rating opinions.

Executive Summary

3. EACRA views the monopolisation of the credit rating industry by three agencies as the driving cause of problems now being faced in the market for sovereign bonds, and previously in the market for structured securities (the "sub-prime" crisis). A change in position by one of only three opinion-makers inevitably has a massive effect. Increase the number of opinions and the impact of one is reduced. In any case, negative ratings do not have a lasting effect on a sovereign or a corporate if there is no financial or economic weakness – bad news is conveyed, not caused, by its bearer.
4. EACRA strongly believes that credit (and other financial) ratings have a major impact on financial markets by increasing transparency, increasing comfort of investors in less well-known names, and conveying specialised financial knowledge to a wider audience. Reforms that contract the demand for credit ratings in order to punish dominant providers do not serve the financial market. Instead reforms should be constructed to favour small innovative providers of credit risk information.
5. EACRA accepts that regulation is essential to maintain the public-good element of wide-spread availability of credit ratings. Moreover, as influential suppliers of opinion, credit rating agencies should be held to a higher standard than other market participants, and if necessary legal remedies may be necessary. At the same time, reasonable safe-harbour provisions, such as verifiable due diligence procedures, are essential to prevent malicious, vindictive or frivolous suits.

Responses to Questions Posed by the Committee

6. A characteristic of a competent credit rating agency should be the clarity with which it explains its rating actions both in particular and in general. Obscure and inadequate explanations should be penalised by market forces. We find it difficult to counter criticism that the recent rating behavior of the dominant credit rating agencies is erratic, obscure and inconsistent with previous ratings. Rating methodologies must develop and are complex, both of which mitigate against the regulation of methodologies, per se.

   a) A rating is an opinion. Whilst it is possible to codify the process by which any opinion (such as a medical opinion or the review of a book) can be reached, the resultant methodology is not something which can be used without thought by an uneducated operator to arrive at a unique result. Mathematical models, whilst important for processing and understanding vast quantities of data, cannot in themselves yield subjective opinions, such as credit ratings.

   b) Ratings look forward and should be compared in time with what actually occurs. There must be a consistency between ratings and events. Where there is no consistency, the rating methodology is wrong and the responsible credit rating agency should be held to account by the market.

7. The credit rating business has inherent and unavoidable conflicts of interest. Issuers are interested in optimistic ratings (as sellers wanting a high price), and investors are interested in conservative ratings (as buyers wanting a low price). At the same time, agencies consistently biasing their ratings will have their product discounted. A truer opinion is gained when opinions from more than one source are available and disparities of approach can be identified and explained.

   a) The regulatory climate since the middle of the last century has lead to a collective monopoly consisting or two or three credit rating agencies. Monopoly conditions tend in most industries to lead to excessive profits, stifled competitions and complacency. We submit that these flaws are what are driving the current criticisms of credit rating behaviour.

   b) There is insufficient competition and it is extremely difficult for a small focussed agency to survive.

8. It is long established practice that where one party in a commercial relationship (eg. a fiduciary) has more information or power, such a party is held to a higher standard. Credit rating agencies only provide opinions, but their opinions have more influence than those of other market participants. It is reasonable for credit rating agencies to be held to a higher standard of conduct and penalised for failing to abide by such standards. Legal remedies for such failures must include reasonable and verifiable safe harbours so that credit rating agencies are not subject to malicious or frivolous litigation.

   a) Poor service in a market should be penalised by a loss in revenue. But that assumes there are substitutes or competitors. The current market structure, in which the ratings of only three agencies are given credibility by regulatory, newspapers, and politicians, does not provide for sufficient alternatives. The three dominant credit rating agencies do not, therefore, suffer any negative

consequences for bad performance, even though bad performance is eminently demonstrable.

9. The existence of credit ratings of all instruments in a financial market has a profound effect on the transparency of the market as a whole, on the comfort level of smaller investors when dealing with lesser known names, and thus on market liquidity. We believe that market-based measures for extract credit risk information cannot substitute independently assigned credit ratings. It is sub-optimal for a market to rely on a single supplier of any sort, let alone credit ratings. Changes by that supplier will inevitably affect the market. Increasing the diversity of credit rating opinions will reduce the impact of any single supplier. The dangerous consequences of being dependent on too few sources of sovereign ratings have recently become manifest.

   a) Insufficient research has been done on the public-good benefits of credit ratings in a financial market. We believe, nevertheless, there is evidence that markets in which credit ratings exist for all financial instruments in the market are more transparent and liquid than markets where credit ratings are scarse.

   b) It is not possible for all investors, particularly small investors, to have the specialist knowledge and access to data needed to analyze all potential investments. Even in large financial institutions with dedicated research teams, the fruits of the research (essentially internal credit ratings) are used by independent teams of dealers. Credit rating agencies increase the ability of investors to allocate their resources.

   c) The financial markets are in need of more credit (and other types of) ratings, not less.

10. There is a world of difference between embedding rating **thresholds** in legislation and embedding the **requirement** for ratings in legislation. It is similar to the difference between requiring a company has some level of profitability and requiring a company has an external audit.

   a) The legislative requirement for a specific rating threshold implies the requirement for a rating, and this has driven the market for ratings, and hence the increase in transparency from the wide-spread availability of ratings. At the same time requiring specific thresholds for regulatory purposes creates distortions because they amplify the pressures on rating agencies by issuers when ratings are crossing the threshold. Regulators like thresholds because they shift the burden of decision from the regulator to the rating agency.

   b) However, if – as is being suggested – all mention of credit ratings is removed from regulatory legislation, the pressure on issuers to spend resources on providing information to the rating agency, paying for the rating, and managing the consequences of adverse comment when a less than flattering report is issued, will disappear. The result will be for large companies to dispense with ratings altogether and market transparency will decline.

11. We are certain the reform proposals being pursued by the European Commission are well-intentioned and have reasonable objectives, particularly a desire to increase competition. We are as certain that the reforms themselves will

have the opposite effects to those intended and will diminish competition and diversity of opinion.

a) Regulatory compliance demands pose a greater burden on small companies than on large companies. All the reforms to date have increased compliance burdens designed with the three dominant rating agencies in mind, with no thought given to the needs of small agencies.

b) Some of the regulations make unwarranted assumptions about the way in which ratings are assigned. This has a major effect on small agencies.

12. All credit ratings, whether sovereign, corporate, or individual are based on assessments of ability to pay and willingness to pay. Political process, social environment, economic system etc are all factors that affect both ability and willingness of a sovereign to pay and must be considered. The problems faced when one agency changes its opinion arises because there are too few such sources. Alternative view points do not exist to balance the change. If a number of agencies, over a period of time, were to change their views, the effect of a single change would not be critical. The opinions of credit rating agencies of corporates can strongly influence some corporates and are ignored by others. We submit this is beneficial to the health of economies. Is it not reasonable to suggest the same would be true for the global economy if there were more sovereign ratings from a more diverse set of sources?

13. Rating downgrades do not cause lasting problems for a corporate or a country in the absence of economic or financial weakness. The bearer of bad news is not the creator of the consequences of bad news. At the same time, the extreme concentration of credit risk information for sovereigns has demonstrated inconsistencies in ratings across time and across countries. Even the dominant credit rating agencies are too small to adequately assess humankind in its entirety.

Recommendations

14. EACRA makes the following recommendations:

a) Change regulatory requirements for rating thresholds into requirements for a rating, analogous to the requirements for financial audits;

b) Remove all regulatory mentions of specific credit rating agencies and refer to accredited credit rating agencies;

c) Recognise credit ratings issued by credit rating agencies accredited in other countries;

d) Promote the development of the credit rating industry by reducing the complaince burden in line with the size of the rating agency.

Conclusion

15. The European Association of Credit Rating Agencies thanks the Parliamentary Treasury Committee for the opportunity to present its views and is ready to provide further testimony.