

WHAT ARE CREDIT RATINGS?



Education Series #1

Definitions

The Credit Rating Agency Regulation 1060/2009 defines a credit rating in Article 3 (1) (a) as a “an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories”.

A practitioner’s definition of a credit rating is an independent, objective assessment of an entity’s creditworthiness, which reflect its ability to meet financial obligations in full and in a timely manner.

Rating scales and categories

According to Article 3 (1) (h) of the CRA Regulation, a rating category means “a rating symbol, such as a letter or numerical symbol which might be accompanied by appending identifying characters, used in a credit rating to provide a relative measure of risk to distinguish the different risk characteristics of the types of rated entities, issuers and financial instruments or other assets”. Credit ratings are therefore a relative measure of credit risk.

The CRA Regulation therefore does not standardize the rating scale to be used by Credit Rating Agencies. Most frequently, rating agencies use the scale AAA to D, AAA denoting the lowest credit risk and D meaning that the issuer has defaulted. Investment-grade ratings cover AAA, AA, A and BBB whereas sub-investment-grade ratings are BB, B, CCC, CC and C. Rating agencies may also use rating notches to provide a more granular measure of the relative credit risk.

Registration with ESMA

Credit ratings may be issued publicly or disclosed by subscription to investors only if the rating agencies is registered as such with the European Securities and Markets Authority (“ESMA”), the sole supervisor of rating agencies across the whole European Union.

Use of credit ratings by investors

Credit ratings may be used by the following investors according to Article 4 (1) of the CRA Regulation: Credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties.

Article 5a of the CRA Regulation requires that the above investors “shall make their own credit risk assessment and shall not solely or mechanically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument”.

Given that rating agencies are registered with ESMA, their ratings may be used by the above investors across the whole European Economic Area.

Requirements on agencies

The CRA Regulation establishes a high number of organisational and procedural requirements on rating agencies “in order to enhance the integrity, transparency, responsibility good governance and independence of credit rating activities” (Article 1 of CRA Regulation). Rating agencies are under the on-going supervision of ESMA.

About EACRA:

The European Association of Credit Rating Agencies (EACRA), set up in November 2009 and registered in Paris, was established to act as a platform for cooperation for EU-based Credit Rating Agencies (CRAs). Our mission is to support and facilitate the compliance of CRAs with regulatory requirements through effective communication, cross-border know how, and the promotion of best practices. In addition, EACRA seeks to promote Credit Ratings and the interests of CRAs across Europe, as well as enhance the financial community and general public’s understanding of Credit Ratings. The association is registered under French directory of Association N° W751202513 and under EU Transparency Register ID 24205924101-57.