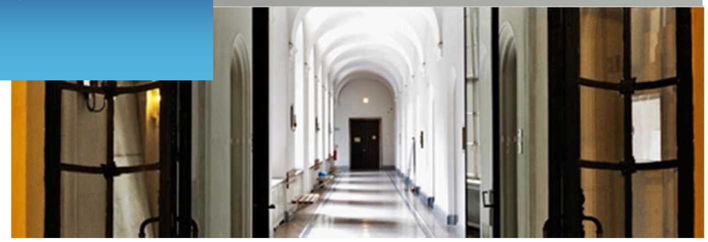
BLACKROCK®

ViewPoint

April 2012

# Reform of Credit Rating Agency Regulation in Europe: An End-investor Perspective



## Introduction

BlackRock is one of the world's pre-eminent asset management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world. We believe that undertaking our own rigorous and consistent credit analysis is paramount to acting in the best interests of our clients and that third party ratings are but one information point in our credit analysis.

Ratings provide a benchmark or a reference point that investors use to evaluate a security or issuer's potential eligibility for the inclusion of that investment in a portfolio. Without globally recognised standards for inclusion or exclusion, investor uncertainty about the credit quality of the investment could undermine the confidence of investors.

The financial crisis brought into sharp focus a number of weaknesses in the Credit Rating Agency (CRA) business model. Regulators, globally, have sought to address these weaknesses in the CRA business model and to modify investor behaviour by discouraging an over-reliance on ratings.

In Europe, the third reform of CRA regulation ("CRA3") since the financial crisis is currently underway.  BlackRock supports the rationale behind many of the proposals in the CRA3 package but we are nonetheless concerned that key elements of the package could impair the investment performance and choice of our clients, amongst which are European households, pensioners and savers.

This paper provides background on the use of ratings in the investment process, establishes the case for further reform of CRAs and the ratings process and summarises concerns expressed by investors with respect to the CRA3 proposal in Europe.

Against this backdrop, we recommend policy makers focus on:

- Analysing the impact of regulation that enshrines the use of ratings in, for example, bank capital and liquidity ratios, and discouraging over-reliance on ratings elsewhere.
- Allowing the market to determine the quality of CRA analysis by increasing transparency, notably by ESMA publishing a matrix establishing CRA's rating performance.
- Implementing existing CRA Regulations to facilitate the effective supervision of CRAs by the European Securities and Markets Authority (ESMA).

## How do Investors use Credit Ratings Today?

BlackRock's active investment philosophy emphasises a commitment to fundamental research and independent credit evaluation. Our research team follows a rigorous process when assessing the creditworthiness of a security. In order to develop a formal view, we conduct both quantitative analyses of corporate capital structures and qualitative assessments of management and industry positioning.

Many clients have investment guidelines which limit their holdings to instruments which carry third party ratings or funds which invest primarily in such instruments.  We consider such ratings as a preliminary screen in our own independent credit review; that is, we use the ratings as a 'starting point' in our assessment of an investment, formulating our own independent 'credit opinion' about an issuer or a specific investment instrument. Our assessment does not end when we purchase a security. Just as each CRA may upgrade or downgrade issues, our credit analysts apply an independent assessment of each security throughout the period that we hold the security in a portfolio which includes monitoring CRA ratings changes.

We believe that this conforms to policy-makers expectations of how investors should use credit ratings.   ESMA has recently clarified – in respect of its money market fund classification – that "management companies should ensure that they have proper procedures and processes in place to enable them to assess the credit quality of an instrument without relying solely on credit ratings produced by credit rating agencies.  In particular, management companies should always conduct an internal assessment of the credit quality as a key element of their decision on whether to invest in that instrument".

The ESMA Money Market Fund classification also defines minimum credit ratings for the securities held by Money Market Funds.  These are A2 for bank and corporate securities and investment grade for sovereign debt.  A ratings downgrade could therefore trigger the disposal of downgraded securities.  ESMA specifies in this case that "the management company should immediately assess how best to bring the fund back into compliance with its guidelines.  It should take remedial action as soon as reasonable practicable, taking into account the best interest of the investors at all times".

*The opinions expressed are those of BlackRock's Government Regulatory group as of April 2012  and are subject to change as subsequent conditions vary.*

**BlackRock's fundamental credit analysis framework**

**Qualitative Analysis**

**Industry Attractiveness**
Macro Economic View
Market Demand / Growth Potential
Revenue / Cash Flow Predictability
Degree of Commoditization

**Competitive Position**
Relative Market Position
Operating Performance
Revenue / CF diversification
Event Risk Potential

**Management Quality**
Experience
Bench Strength
Operating track record

**Quantitative Analysis**

**Leverage**
Ability to repay obligations
Debt market access
Resiliency / "shock" absorbency

**Liquidity**
Back up liquidity
Refinancing needs
Covenant compliance

**Equity Market Perspective**
Equity market access
Investor confidence
Event risk potential

**Key Positive Characteristics**

- Leading business in its industry
- Strong management team
- Pricing power and ability to maintain / expand margins
- Free cash flow to reduce debt
- Strong covenants and prudent capital structure
- Catalyst to reduce credit risk and drive value higher

**Key Negative Characteristics**

- Highly volatile revenues / cash flows or minimal operating cash flows
  - Seasonal, project-oriented or start-up companies
- Downside risks that cannot be clearly defined
  - Litigation, environmental, regulatory, etc.
- Weak management teams
- Industries at a competitive disadvantage

## The Case for Further CRA Regulatory Reform in Europe

We strongly support the objectives of enhancing transparency and discouraging over-reliance on credit ratings, themes which run throughout the European Commission's (the "Commission") CRA3 proposal. We believe that the CRA3 proposal should incentivise behaviours so that ratings are more of a tool with which to begin credit risk analysis, rather than as definitive measures of credit risk *per se.*

Another important contribution of the new proposal concerns the prevention of conflicts of interest. Influence can be applied in many indirect ways so we consider it to be vitally important to reinforce the split between rating content and process.

The Commission proposal also seeks to prevent conflicts of interest by limiting major cross-shareholdings among CRAs. Importantly, the Commission recognised the difference between public ownership of public stock and private placements. The proposal consequently exempts from any such limitation on crossholdings by diversified collective investment schemes such as UCITS and managed funds such as pension schemes or life insurance companies. The exemption recognises that index funds, for example, are obliged to invest in all the securities in a given index and cannot choose not to invest in any one of the securities in that index because they are a CRA.

Ultimately, end-investors want to ensure that CRA regulation focuses on ensuring that globally consistent, comparable, reliable high quality information points exist on an issuer's credit worthiness.

## Key Concerns with "CRA3"

Notwithstanding the many positives for investors that could result from the Commission's proposal, its provisions are far reaching and could well result in inconsistent ratings on a global basis.

Specifically, if the CRA3 proposal is left unamended we are concerned that:

- It could create ratings that are distinct and not comparable with non-EU ratings.
- This would increase uncertainty about the credit worthiness of European debt relative to non-European debt. This could result in investors demanding a higher risk premium for holding European credit.
- Damage the analytical quality and usefulness of ratings on European debt.
- Encourage less stable ratings to the detriment of both investors and issuers.

Three issues are of particular concern and require further consideration:

- Regulatory influence in the ratings process.
- Mandatory rotation.
- Civil liability regime.

### Regulatory influence in the ratings process

Requiring regulatory approval for new methodologies is fraught with unintended consequences and has serious implications for global investors.

- **Global comparability of ratings undermined.** Absent a binding harmonised global approach to determination of ratings methodologies by regulators, inconsistency of ratings would result. This would call into question the comparability of EU ratings with non-EU ratings to the detriment of sound and consistent credit analysis by investors.

- **Diversity of ratings reduced; information points for independent credit analysis suppressed.** Investors do not agree that there is a verifiably correct way of assessing creditworthiness. The quality of credit analysis ultimately depends on the diversity of information points as inputs into holistic independent credit analysis. Investors fear that the Commission's proposal in respect of regulatory influence in ratings could ultimately lead to more homogeneous methodologies and therefore less diversity of views on European credit risk.

### Mandatory rotation

The Commission proposal rightly focuses on discouraging over-reliance on ratings. The proposed mandatory rotation requirement undermines this objective by creating uncertainty, which will ultimately impact end-investor behaviour.

- **Uncertainty for investors**. Under mandatory rotation, repetitive stopping and starting of ratings coverage will inevitably lead to more frequent ratings changes. At the portfolio level, since ratings define certain investment risk parameters, changes to those ratings may trigger buying or selling activity of the assets with which portfolios are composed. Frequent buying and selling of assets not only would raise the cost of investing. It would also create uncertainty in the investment process for pensioners and savers and could accelerate client redemptions.
- **Erosion of investor confidence in ratings**. The rotation requirements would create a highly inefficient and disruptive system involving frequent changes of ratings limiting investor appetite for the rated debt. Issuance of longer-term debt may be particularly affected, as investors will discount ratings that are destined to be rotated before the debt matures.
- **Ratings changes may trigger redemptions**. For many investors, ratings represent a key component of the investment decision. Frequent changes in ratings may have the effect of encouraging unnecessary market volatility as investors are influenced negatively or are forced to redeem due to the deterioration in credit quality implied by a changed rating. This change in rating may simply be the result of one CRA placing greater or lesser weight on certain quantitative or qualitative factors in a rating assessment. In other words, investor behaviour may be influenced due to a change in methodology rather than an issuer's worsening credit condition.
- **Poorer quality ratings will result.** CRAs developed long term historical models that have been refined over time through intensive back testing. The amount of human labour and capital costs with developing these proprietary models is high so it would not be credible or even justified to require CRAs to share many of the 'unique' aspects of their models or ratings process when they hand over their rotation slot to another CRA. Mandatory rotation creates a built-in disincentive for ratings firms to compete on the basis of analytical quality, as they will simply have to wait their turn in order to win business.

### Civil liability regime

The proposed civil liability regime reverses the current burden of proof arrangements reducing the number of issues rated and increasing the cost of using ratings. This outcome would ultimately be to the detriment of Europe's issuers and end-investors and potentially undermines the Commission's stated goals of avoiding over-reliance on ratings.

- **Ultimately, rating agencies issue opinions**. Existing regulation has enshrined their importance creating over-reliance and false comfort for regulators and certain market participants who do not conduct their own rigorous credit analysis. Two credit analysts can look at a set of data and interpret a meaning that is entirely different from one another. Estimates of forward looking events are subject to varying factors including for duration of the forecasting cycle and the independent variables inputs factored into rating agency matters. Since all assigned ratings include an element of forward looking assumptions, a rating agency ought not to be penalised because events could transpire in the future that vary from what is assumed when the opinion was first issued.
- **Civil liability could create greater reliance on ratings, a situation investors are trying to avoid**. Introduction of civil liability could introduce a new "claims culture" into the investment process since investors could claim that reliance on a rating resulted in a loss. We support the Commission's stated objective of decreasing over-reliance on ratings and believe the introduction of civil liability would unintentionally facilitate further reliance on ratings.

## Recommendations

Against this backdrop, BlackRock recommends that the following alternatives be adopted:

#### ***Ratings Support for the Internal Credit Analysis Process***

For the purpose of investment managers' credit analysis, we would encourage policy makers to underscore the importance of ratings being understood to be opinions informing holistic and independent credit analysis. Clearly, it would be inappropriate to apply civil liability to ratings being used in this way – as credit opinions - a point recognised by the Securities and Exchange Commission (SEC) in the United States. The SEC has issued a reprieve from Section 939(g) of the Dodd Frank Act on 23 November 2010 whose effect was to allow public Asset Backed Securities (ABS) and debt issuers to not disclose ratings in these filings.

Globally agreed bank capital and liquidity rules have the potential to enshrine the use of ratings in regulation. Without calling for a fundamental review of the Basel Committee's approach to bank capital rules – which is not the intention of this paper – it is implausible to call for an end to the "hard wiring" of ratings in regulation. We believe the impact of "hard-wiring" should therefore be assessed over time and the findings used to judge if further amendment to bank capital rules would be warranted.

In summary, we firmly believe that ratings should serve as an initial screen for an independent credit review. The elimination of references to ratings may inadvertently result in the creation of new risks as lower quality securities may be deemed creditworthy by advisers.

***The Market Determines the Quality of CRA Analysis***

We propose determination by the 'market' of the quality of CRA analysis. The proposal should allow the 'market' to determine the reliability and the strength of each CRA's ratings process for specific asset classes. The 'market' in this example means investors and other end-users of CRA ratings.

- For each asset class (ABS, RMBS, CMBS, sovereign debt etc.) ESMA could publish a Standardised Ratings Transition Matrix for long and short term ratings.
- A Ratings Transition Matrix shows on average over time the quality of each CRA's ratings performance pertaining to a particular asset class.
- Each CRA should develop a Ratings Transition Matrix for each asset class for the most recent trailing 12-month period and over a prolonged period.
- These matrices should be published at a minimum of once annually so that investors and end users can review the performance of each CRA for various asset classes.

***Implement existing CRA Regulations to facilitate effective supervision of CRAs by ESMA***

Implementation of existing EU CRA regulations, which are expressly designed to ensure the quality, independence and objectivity of credit ratings will, we believe, address most regulatory concerns. ESMA oversees adherence with these rules, has extensive powers of inspection and can levy substantial penalties in the event of breaches of the regulations. As part of ESMA's inspection regime, it can assess the quality, independence and transparency of the policies and processes employed to develop and implement methodology and criteria changes.

## Conclusion

Ratings have provided investors with globally comparable information points which facilitate investment managers' holistic and independent analysis of credit worthiness of a debt issue or issuer. Problems of possible over-reliance on ratings need to be tackled. Potential conflicts of interest within CRAs need to be managed.

We are concerned that the positive reforms proposed by the CRA3 legislative package would be undermined by the application of strict civil liability provisions, a mandatory rotation requirement and excessive regulatory influence in ratings. If unamended in these important areas, the CRA3 proposal could lead to a deterioration of the conditions for investment in Europe, putting it and its end-investors, such as European households, pensioners and savers, at a distinct disadvantage during the current challenging economic conditions. We believe the alternative proposals we have put forward would improve the fortunes of end-investors and would therefore encourage their adoption in the current legislative process.

**Related *ViewPoint* Paper**

- Money Market Funds: The Importance of Credit Research and NSRO Ratings

For online access to *ViewPoint* series:
http://www2.blackrock.com/global/home/PublicPolicy/ViewPoints/index.htm

fund (nor shall any such shares be offered or sold to any person) in any jurisdiction within Latin America in which an offer, solicitation, purchase or sale would be unlawful under the securities law of that jurisdiction. If any funds are mentioned or inferred to in this material, it is possible that they have not been registered with the securities regulator of Brazil, Chile, Colombia, Mexico and Peru or any other securities regulator in any Latin American country and no such securities regulators have confirmed the accuracy of any information contained herein. No information discussed herein can be provided to the general public in Latin America.. All other trademarks are those of their respective owners.

The information provided here is neither tax nor legal advice. Investors should speak to their tax professional for specific information regarding their tax situation.

Prepared by BlackRock Investments, LLC, member FINRA.