“Shadow ratings”: Background and a proposal for amending CRAR

Background
The object of the Capital Markets Union (CMU) is to enhance the efficiency of capital markets in support of the wider economy, in order to stimulate growth and job creation. The Nordic bond market has become an important source of funding for SMEs and savings banks, creating a significant and alternative funding source for medium sized corporates. Several features of the Nordic and Norwegian bond market could serve as ideas for how to improve the efficiency of corporate bond markets, and corporate finance in general, in which companies and investors can transact in a cost-effective, stable and fair manner.
“Shadow ratings” is one of those features. Several Norwegian banks and investment firms have for years been publishing «shadow ratings» as part of their investment recommendations for fixed income securities. Investment research is subject to the MiFID and MiFIR regulations. Recently, ESMA has strongly indicated that the publication of «shadow ratings» is within the scope of the Credit Rating Agency Regulation (CRAR).
A prohibition of «shadow ratings» on formalistic grounds by ESMA could work counter to the important goals of the CMU. It is our opinion that «shadow ratings» are not detrimental neither to investor protection nor to financial stability. On the contrary, «shadow ratings» enhances investor protection as:

- They cannot be controlled by the single issuers
- There is a self disciplinary market mechanism in place as several different banks/investment firms publish such ratings on each issuer on their own initiative
- They provide highly important information regarding credit risk and pricing

The Norwegian bond market
We assess the Norwegian bond market as a well-functioning market for SMEs and small savings banks entailing:

- Normal loan size: EUR 15-500 mill. (median: EUR 50 mill.)
- Efficient and standardized loan documentation (30-40 pages)
- Fast process

Measured per capita, the volume of Norwegian high yield issuances has for some years been between 3.5 and 8 times larger than within EU. The Norwegian high yield market is a critical alternative source of funding for borrowers representing a higher credit risk due to general risk (the underlying business) or some specific risk factors (for example technology), meaning that access to ordinary bank funding could be restricted or too costly.
Several factors have strongly contributed to the development of the Norwegian bond market, creating an important and alternative funding source for medium sized corporates:

- Efficient documentation processes, facilitated by Nordic Trustee
- Efficient electronic securities depositary systems (VPS)
- Methods and models for mark-to-model pricing (Nordic Bond Pricing)
- «Shadow ratings» published and regularly updated by several banks and investment firms for each issuer

The rating situation in the market could be described as such:

- *Financials:* Almost all of the covered bond volume has an official rating. Of the 25 covered bond programs in Norway, only the four smallest do not have an official rating. However, only 19 (the largest) Norwegian banks have official ratings (of a total of 127 banks).
- *Utilities*: Two Norwegian Power Utilities (Statkraft and Statnett) have official ratings
- *Non-Financial Corporates*: Only a few issuers have an official rating, and quite large issuers do not have official ratings (E.g. NorgesGruppen, Nortura, Tine, Kongsberg Gruppen, Seadrill, DOF, Teekay Offshore, Aker, Olav Thon Eiendomsselskap, Entra Eiendom).
- *Municipalities:* Oslo kommune and Stavanger kommune have official ratings, representing EUR 3,4 bn. of approx. EUR 15,6 bn. of bonds and commercial paper outstanding from municipalities. “Shadow ratings” do not comprise municipalities.

Investors accept “shadow ratings” for information purposes and in mandates, even though such ratings are not relevant for capital charges. Moreover, official ratings are effectively prohibitively costly for small and mid-sized firms. As is recommended by the Norwegian Asset Manager Association (VFF), many asset managers require each issue to be either publicly rated by at least one official rating agency *or* shadow rated by at least two different broker firms or banks. «Shadow ratings» are also an important source of information for mark-to-model valuations.

Why is it not necessary to regulate «shadow ratings»?
«Shadow ratings» cannot be utilized to reduce capital requirements for credit institutions and insurance companies. The issuers are not in control of the «shadow ratings» as they are not ordered or paid for by the issuers, and they cannot be kept back from the market by the issuers. «Shadow ratings» are published by a handful of competitors, which constitutes a self-disciplinary market mechanism.

Proposed amendment to CRAR Article 2
We would like to propose the following amendment to CRAR article 2, the amendment being highlighted in bold text below:
1. This Regulation applies to credit ratings issued by credit rating agencies registered in the Community and which are disclosed publicly or distributed by subscription.
2. This Regulation does not apply to:
(a) private credit ratings produced pursuant to an individual order and provided exclusively to the person who placed the order and which are not intended for public disclosure or distribution by subscription;
(b) credit scores, credit scoring systems or similar assessments related to obligations arising from consumer, commercial or industrial relationships;
(c) credit ratings produced by export credit agencies in accordance with point 1.3 of Part 1 of Annex VI to Directive 2006/48/EC; or
(d) credit ratings produced by the central banks and which:
(i) are not paid for by the rated entity;
(ii) are not disclosed to the public;
(iii) are issued in accordance with the principles, standards and procedures which ensure the adequate integrity and independence of credit rating activities as provided for by this Regulation; and
(iv) do not relate to financial instruments issued by the respective central banks' Member States ***;***
(e) investment research that includes a credit rating, but that are not ordered and paid for by the issuer and that cannot be taken into account for regulatory purposes*.*