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From Brussels

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Euler Hermes Rating at EP Workshop on Credit Rating Agencies: A European Framework for CRAs?

On 04.12., European Parliament's Economic and Monetary Affairs (ECON) Committee held a workshop on credit rating agencies. Euler Hermes Rating was invited to provide its view on future regulations on rating agencies.

In a global market, business has become much more volatile. Today, annual statements are no reliable indicators of future performance anymore. Euler Hermes Rating believes that a high quality rating opinion can only be provided by high quality rating analysts capable of analyzing and judging the future risks of the issuer's business model. Assessing management and organizational capabilities, market position and competitive forces, controlling instruments and corporate planning is vital in order to provide an

opinion on future debt service capacity. This in mind, Euler Hermes Rating has conducted issuer ratings on nearly 150 mid to large size corporations. The rating process is a due diligence like approach that takes 30 to 40 man days.

It was a common understanding during the session in Brussels that, despite the financial crisis, rating agencies have provided accurate opinions on the debt service capacity of issuers. However the opinions on structured finance products led to a global crisis in the banking industry and now caused the whole global economy to collapse.

In the opinion of Euler Hermes Rating, it was a mistake to provide ratings of financial instruments performed by analysts who had extensive knowledge in quantitative analysis but did not understand the assets of the underlying credit facilities and the risk involved. A similar mistake has been made in the European Mezzanine market. Issuers have been rated based on quantitative balance sheet analysis while the analysts did not understand the underlying business model and the future risks involved. After three years we now see more than 3% of the BBB or better rated issuer default, a number that should have occurred only after seven years, and the economic downturn has just started.

Therefore, Euler Hermes Rating suggests some changes to the future rating world. First, there needs to be more competition in the rating market. When the international financial community refers to "rating agencies" they generally refer to Standard & Poors, Moody's Investors Service and Fitch Ratings. Other Rating agencies are less accepted although they have provided excellent rating opinions in the past.

In order to provide more accurate rating opinions, rating methods should be approved and acknowledged by the financial regulators. Once approved, every rating agency should be accepted by the financial industry. This would lead to more competition, and financial regulators could benchmark rating methods on a qualitative basis. As a precondition regulators must hire highly qualified people capable of assessing and approving agencies' rating methods.

Besides the requirement of preparing annual financial statements, all medium enterprises should have one and large enterprises should have two independent issuer ratings. Annual statements look at past performance, rating opinions assess future risks. Therefore lenders should not only use annual statements in credit assessment, but also independent forward looking issuer ratings.

Ratings of structured finance products should be based on the aggregated and weighted issuer ratings of the underlying assets, and all ratings should be mapped to an internationally accepted rating scale to make them comparable.

Euler Hermes Rating believes that only the complete understanding of a business model and the comprehensive discussion of the risks involved can lead to an accurate rating opinion.