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Mutual Fund Managers and Trustees Circular
On Reliance on Dual Ratings in Investment Selection and Management

Att:
Mutual Fund Managers and Trustees
By YAEL [ISA's secure mail system]

Dear Mutual Fund Managers and Trustees,

Background

The world is experiencing the significant macroeconomic implications stemming from the spread of the coronavirus in many countries across the world, including Israel ("the Coronavirus Crisis"). This crisis, and the restrictions on movement imposed in Israel and in other countries as part of the efforts to prevent the spread of the virus, has created enormous challenges for the economy, which are reflected in an unprecedented decline in both the level and pace of business activity. Israel and other countries have recently taken various steps to address the economic consequences of the Coronavirus Crisis, including interest cuts, government bond purchasing programs, grants, subsidized loans, tax relief, and other measures.

Recent weeks have been characterized by sharp movements in securities prices across the world's major exchanges, and on the Tel Aviv Stock Exchange, the prices of commodities and various risk assets are showing increasing volatility. In addition, we are seeing the beginning of a trend to downgrade bonds or suspend credit ratings, and it is reasonable to assume that this trend will continue in the near future in view of the implications of the developing crisis for real economic activity.

Dual debt ratings

Dual debt ratings have become common in many of the world's developed markets. Credit rating reports are occasionally issued by multiple rating agencies in response to demands of institutional or other investors, or at the initiative of issuers who believe that multiple ratings will expand their potential investor base. A study by ISA staff on North American and Western European issued bonds found that approximately 87%, in monetary terms, of all bonds issued, are rated by one of the three major rating agencies (S&P, Moody's, and Fitch), and 77% of the value of these series are rated by at least two of these three rating agencies.

In Israel, however, no significant market for dual ratings has developed, and only few companies have adopted a dual rating standard. For example, 46% of the monetary value of the bonds issued to the public have a dual rating – yet these bonds were issued by a mere 15% of all reporting entities that issue bonds, and most belong to the financial sector (banks and insurance companies).

A dual credit rating system has several advantages:

- Dual ratings provide accessible information and a second opinion on a company's financial position, and improve investment decision making and efficient price discovery especially in a market as unique as the Israeli bond market, which is open to retail activity and is traded on the market continuously.[1]
- Dual ratings offer two opinions based on different methodologies. For example, Midroog may rate bonds directly, using a local rating scale, while Ma'alot may first calculate a global rating scale, which it then converts to the local scale, using the conversion table published on Ma'alot's website.[2]
- A credit downgrade by one of the two rating agencies constitutes a warning indication that informs investors' decision making. This information is of increased importance during a capital market crisis, and specifically during periods of significant uncertainty in the capital market.
- Dual ratings reduce concerns of the inherent conflict of interest that accompanies ratings shopping, taking into account the terms of the agreements between rated and rating agencies.
- In Israel, investors' reliance on credit ratings has a significant impact on the design of deeds of trust with respect to stress events, including financial covenants and terms for demanding immediate repayment based on changes in a bond's credit rating. Therefore, defining adequate protective mechanisms in deeds of trust, including a dual rating requirement, should improve investors' positions.
- Encourage competition in the rating market - markets that established a multiple rating regime have created business environments that encourage additional rating agencies to assess the economic feasibility of operations in those markets.

[1] Rather than OTC in transactions among institutional investors, as is the case in the majority of the developed bond markets across the globe.
[2] According to the conversion table, the global rating of A- is equivalent to the highest local rating of ilAAA.

Dual credit ratings may, however, have shortcomings, mainly in terms of the added costs to which corporations may be subject, and in view of the current rating market in Israel, which comprises only two rating agencies. Dual ratings may also create subpar activity of the rating companies because in a dual rating system, ratings of two companies will typically be identical or will differ by no more than one notch.

The ISA recently published a document on hybrid bonds, and illustrated the enormous importance of dual ratings at issuance. These effects also apply to additional debt instruments. Investors should use the tools available to them, and exercise their influence over the design of deeds of trust to confirm that the appropriate conditions are included therein and ensure that dual ratings in these products are maintained over the entire lifecycle of the debt.

How mutual fund managers can use corporate or credit ratings to assist them in their investment decision making

In view of these considerations, the ISA looks favorably on creating incentives to develop a market standard that gives preference to dual credit ratings of bonds, within the parameters that mutual fund managers take into account when making a decision to hold or invest in a bond. The ISA believes that dual ratings should be given added weight in view of the contribution of dual ratings compared to a single rating.

The ISA stresses that it is not calling on fund managers to alter the degree of their reliance on a company's credit rating when making investment decisions. Moreover, in the event of a material change in the company's business or the terms of its bonds, fund managers have a duty to deliberate the issue in their relevant debt or other forums. Therefore, fund managers should monitor corporations' reports and assess their implications for default risks, and not rely exclusively on credit ratings. At the same time, fund managers should be attentive to changes in the credit ratings themselves, and to irregular events, such as the discontinuation of ratings by a rating company, and should conduct discussions in the relevant forums when making decisions with respect to the securities in question.

The ISA plans to issue incentives to reporting corporations that elect to adopt a dual credit rating model for the bonds they issue.

Sincerely,

Avi Laor, Adv.

Deputy Director

Mutual Funds Supervision Unit