COMMENTS RECEIVED IN RELATION TO THE CONSULTATION REPORT

The Role of Credit Rating Agencies In Structured Finance Markets

OICV-IOSCO

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Contents Page

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IOSCO Consultation Report: The role of credit rating agencies in structured finance markets March 2008

Introduction

The Association of British Insurers (the ABI) welcomes the opportunity to respond to this Consultation Report.

ABI members manage assets, on account of the business of their life and general insurance interests, of the order of £1,300bn, as well as assets for third party clients. Amongst these assets are significant investments in fixed-income including structured finance, with a particular focus on the Sterling fixed market and treasury-style money market funds. Our members are not significant investors in floating rate RMBS or CDOs.

General Comments

We are generally sympathetic to the analysis of the role of CRAs in structured finance markets.

Our members consider that CRA ratings are only one of several inputs into the investment decision-making process. A number of ABI members have their own in-house analytical resources which provide the equivalent of ratings from CRAs. These institutional investors are aware of the limitations of current CRA activity.

The key requirement for these investors is to have all the appropriate information required from whatever sources, on a timely basis, for their decision-making purposes. The markets, including regulators, will derive greater benefit from ensuring the availability of this larger information universe than concentrating on one aspect such as CRAs. However, it is acknowledged that CRAs have been dominant in providing information about structured finance and the market has now recognised this weakness.

The market and regulators need to consider how to address this specific issue, but at this stage we see little, if any evidence that an intrusive regulatory regime for CRA's would provide benefits to investors. We therefore welcome this initiative to adapt the IOSCO code to evolving market conditions.

Hitherto we have adopted a position in favour of self-regulation, based on adherence to the IOSCO Code as the appropriate mechanism for a global industry, buttressed by competition in methodology between CRAs and low barriers for new entrants into the industry. The current debate offers an opportunity to test this view, especially as applied to the particular area of structured finance. We recognise the challenge in adapting the Code and the probability that regulation will follow if this fails, but we believe the Code approach should be pursued first.

Comments on the Recommendations

- Quality and integrity of the Rating process. Recommendations 1-8

We agree with the scope of the recommendations. With respect to Recommendation 1 we believe that the compliance/quality control function should not report to profit centres and specifically the heads of ratings business units, as a means of maintaining independence. With respect to Recommendation 2, again, we believe that maintaining independence is more easily achieved if the function does not report into the heads of rating business units.
Recommendation 5 can appear unnecessarily restrictive. CRAs constantly assess and test the market appetite for new products. This is our experience with major CRAs. A new product is unlikely to produce profit unless it meets a market need. With respect to Recommendation 7, we believe that the boundary between Code 1.14 and proposed 1.14.1 is likely to raise issues of interpretation given that the iterative process in manufacturing structured products has been equated to advice in some quarters. We do not see this as an issue provided that there is adequate disclosure overall. Further we believe CRAs should be encouraged to apply a "normal" distribution to ratings on any new product they rate. This would avoid a repeat of the bias towards AAA seen in structured finance earlier in the decade. CRAs could be required to justify any material deviation from a "normal" rating distribution in a particular asset class by reference to default statistics over a time span of at least ten years.

- CRA Independence and Avoidance of Conflict of interest. Recommendations 9-12.

We agree with the scope of the recommendations. Whilst we agree with the tenor of Recommendation 10 there is a further factor to be considered, namely the performance objectives of the heads of the ratings business units. The more that heads of business units responsibility extends from control of analytical output to other areas, particularly budget control of the business unit, the greater the potential scope for compromise on independence and avoidance of conflict.
In addition we suggest that CRAs commit not to link analysts' compensation or promotion to rating fees generated by the individual analyst or their respective department. Notwithstanding that ratings are assigned by a committee or the agency itself, there could be merit in lead analysts signing a declaration at the end of rating reports similar to those required from sell-side analysts. These latter two measures would seek to prevent any temptation to reward analysts for rating decisions which increase the demand for credit ratings.
There should be a ban on any form of compensation linked to CRA's earning performance or share price.
With respect to Recommendation 11 we believe the 10% is unlikely to bite on the major CRAs and could reasonably be reduced to 5%.

- CRA Responsibilities to the Investing Public and Issuers. Recommendations 13-18.

We agree with the scope of the recommendations.

With respect to Recommendation 14 we understand the motive that lies behind it. We can foresee implementation issues. On the grounds of symmetry and market best practice consideration should be given to a similar disclosure requirement on originators, underwriters or sponsors of structured finance products (though we recognise that this is beyond the scope of the Code).

- Disclosure of the Code of Conduct and Communication with Market Participants. Recommendation 19.

We fully endorse this recommendation.

Rating Symbols

Our members do not currently favour using a different set of rating symbols to differentiate structured finance ratings from ratings of corporate debt securities. They value timelines, consistent quality and comparability in the default assessments provided by CRAs. That this is difficult to achieve across markets, such as municipal, corporate or structured finance or indeed within particular sectors of a market, such as retail versus utilities, is one reason why our members do not place too great a reliance on ratings.

Implementation of the Code

We welcome the principles-based approach in the IOSCO CRA Principles and the IOSCA CRA Code of Conduct as the appropriate way to deal with a global environment of CRAs of all types and sizes, using all types of methodologies and operating under a wide variety of legal and market environments. We believe that a comply-or-explain approach facilitates the flexibility that part of the environment that can encourage competition between CRAs and innovation in methodology.

April 2008

The Association of Corporate Treasurers

Comments in response to Consultation Report

The Role of Credit Rating Agencies in Structured Finance Markets

Technical Committee of the International Organization of Securities Commissions, March 2008

April 2008

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments. This document is on the record and may be freely quoted or reproduced with acknowledgement. The ACT welcomes the opportunity to comment on your consultation.

In this case we have consulted our membership through our credit ratings working group and our Policy and Technical Committee. Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf.

These comments are on the record and may be freely quoted with acknowledgement.

General

We welcome the opportunity to express views on this matter.

We comment from the point of view of non-financial corporations. Accordingly, we will comment directly on only a few of the consultation's proposals.

Comment

Corporate and sovereign ratings

In general we consider that corporate and sovereign ratings by the principal credit rating agencies ("CRAs") have worked well. It is important not to weaken this ratings sector in responding to issues arising in other ratings sectors.

Structured finance ratings

Rating designations: symbols

We consider that a simple suffix indicating a structured finance rating is desirable.

The function of credit ratings is to provide information about the opinion of the CRA about the rated obligations. The clearer the information, at reasonable cost, the more valuable the communication becomes.

It is important, therefore, that any rating scale used is not over-complicated and is both clear and widely understood.

An individual rating of an instrument/issuer has to be seen in two contexts:

- "Vertical" – the relationship with the rating of other similar instruments/issuers with higher or lower credit risk
- "Horizontal" – the relationship with the rating of other types of instrument/issuer.

The traditional vertical relationships in default probability indications, with their minor variations (AAA, Aaa, etc.), are quite well known and it would be unwelcome if this were to be changed.

Comparing ratings between risk types is more dangerous territory.

CRAs necessarily use different methodologies in rating different types of instruments/issuers and in subsequent monitoring. Here, this may mean that that a rating of a structured product can be qualitatively different from that of a corporate or sovereign security. If it is not obvious, this may be deduced, from CRAs' methodology descriptions.

Certain CRAs in rating money market funds[1] draw attention to the different methodology in rating and frequency and mode of monitoring by using a suffix letter – as AAAm, etc. – and this is very effective. We think that this provides a good model for structured credits.

So, the CRAs should consider appending a simple suffix for structured finance ratings, e.g. AAAsf, to guide investors and other market participants towards referring to the specific approach taken in evaluating the particular type of structured finance[2].

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[1] We refer to money market funds of the kind established under Rule 2a-7 of the United States Investment Company Act of 1940 and similar funds elsewhere.

[2] This must not be made over complex. As many types of structured financings can be invented, to try to give more detail in the rating symbol would nullify the "quick guide" nature of the basic symbol. If CRAs want to provide easy comparison between structured credits (reading published written research for several securities can take time), they can publish separate ratings of particular characteristics. That some CRAs publish separate "loss

Too many suffix types could weaken rather than improve the effectiveness of communication, of course. We do not see that problem with limited use of suffixes[3].

Other background comments

Independence and Avoidance of Conflicts of Interest

The "issuer pays" business model adopted by the main CRAs following the collapse of Penn Central, which seems at first glance to have inherent conflicts, has worked well in practice. Any apparent conflict of interest seems relatively simple and transparent. Furthermore, other factors mitigate any risk, much as the consultation notes:

- First, what corporate issuers are buying is the credible information provided by the rating report by the CRA and the easily accessible quick guidance provided by the rating symbol allocated. The credibility of the CRA is fundamental to the transaction.
- Second, a major part of the cost of a rating for a corporate issuer is the management time taken up in securing/maintaining the rating. So the CRA knows that (within reason) its fees for the rating given will not cause a corporate issuer to switch agencies. Bringing a new agency "up to speed" is just too much trouble. Technically, the opportunity cost of the management time simply too high. So, except in maverick cases, there is no real pressure on a CRA to give a "high" rating in order to preserve the income stream.
- Third, the main CRAs commit to rating a company once they have started, so the issuer knows that cancelling the agency contract at the first opportunity will not stop the issuing and updating of an unwanted rating: there would only be the minor satisfaction that eventually the company would stop paying the agency.
- Fourth, in the matter of future issues by the issuer, the above arguments apply – so it is very unlikely that there is any pricing or rating pressure on a CRA to compromise itself in order to receive fees on rating future issues.
- Finally, investors usually require ratings from one or more of a small number of established CRAs and, for this reason, realistically, companies are unlikely to find an easier ride when they turn to another agency.

Also, it is unlikely that the alternative user-pays model would generate sufficient revenues for the credit rating of other than the largest issues. Most issues would not be rated. This would seriously weaken flow of information to investors and make issuance much harder and more expensive for most issuers and this would not be in the public interest. An analogy is seen in the equity markets where analyst coverage of smaller companies is seriously limited. The large US private placement market, with alternative rating procedures is also interesting for comparison. Investors are large/sophisticated enough to develop a relationship with the issuer and make their own credit assessment.

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given default" ratings to complement corporate default ratings illustrates what we have in mind.

[3] Corporate and sovereign securities are inherently different in many characteristics, but this has been well understood over the years and we doubt if, for them, suffixes would add value.
The only other instance where suffixes might be considered is in rating of US municipal and State issuers. The problems of "monoline insurers" have drawn attention to the very low historical default rates for such issuers compared to those of corporates of similar rating. If this phenomenon were considered inherent but not widely understood, it may be argued that some suffix might be appended to distinguish municipal ratings.

Public ratings from the major CRAs are significant among the information sources for investors not in this favoured position.

On the other hand, as each structured financing is (more or less) unique, there is no, or little, saving in management time by sticking with the same CRA after other agencies have rated that type of credit. I.e. there really is a credible risk of potential price and ratings conflicts of interest for CRAs regarding new structured financing ratings. Of course the CRAs have/should have procedures in place to manage the risks arising from this.

Probably the issues associated with the user-pays model, discussed above, would also apply to structured ratings.

We are sure that the main CRAs, aware of the points set out above, seek to have appropriate structures and systems in place to handle them well.

Even so, a strengthened code of conduct regarding the stronger conflicts in respect of structured ratings may also be appropriate – especially if new CRAs are encouraged into the market.

Competition

The absence of the high (opportunity) costs in management time in switching CRAs noted above for corporates makes competition more of a factor in structured markets. Competition has positive aspects but here it increases the importance of the conflicts of interest in the CRA revenue model in structured markets. If there are to be more competitors in structured markets, a strengthened code of conduct may be appropriate.

Level of CRA or other due diligence

CRAs generally rely on the statements made to them by the sponsors of the structured credit in the same way as they rely on statements made to them by corporate or sovereign issuers provided they are not manifestly in error or inconsistent with other information available to the rating agency.

It has not been the role of CRAs to conduct a separate audit/due diligence and we do not believe that it should be. This is not an area where they have the necessary expertise[4].

Historically, the structured-credit SPV issuing the securities and any security trustee would rely on the representation and warranties of the sponsor as regards the attributes of the underlying assets. Breach would trigger a put from the SPV to the sponsor. Proof of breach however could very difficult, but the recourse was there in principle.

Over the years the representations and warranties have been watered down to be less and less meaningful. Purchasers of the securities do not seem to have focused on this. The prospectuses (most issues are listed, although there have been some private placements) are long and little read. More investor due diligence is indicated.

More due diligence by the rating agencies or by accountants or lawyers working for the SPV in respect of the securitised portfolios, e.g. by random testing of the attributes of the underlying assets, for example mortgage loans, forming part of it could address the point. However, this would have a very adverse effect on the timetable for and cost of

[4] It is important to distinguish between the monitoring of reported positions (e.g. in the rating of liquid money market funds – see footnote 1) from auditing the underlying positions.

the proposed issue. In a portfolio of, say, 20,000 mortgages, how many underlying files would have to be looked at carefully? 200? 2,000? This would take weeks and cost a lot.

The absence of such due diligence, however, leaves a securitisation system open to abuse particularly in the face of investor reluctance to read prospectuses and assumption that a credit rating was an indicator of price and liquidity.

We are sure that more requirements on CRAs are not a solution to this.

Comments on specific recommendations

Recommendation 6 (Appropriateness of existing methodologies and models)

We consider that this recommendation is overly restrictive.

We agree, of course, that the CRA should not, potentially misleadingly, force the rating of a novel instrument into an unsuitable established category of rating. However, why should a CRA be constrained from using a new structure or category of rating to accommodate the novel instrument, provided that it makes it clear what it is doing and publishes its methodology, etc. appropriately per recommendation 13 and elsewhere in the code?

Recommendation 7 (Proposals or recommendations by CRAs on structured finance products they rate)

Recommendation 7 is expressed to be relevant to structured ratings.
The key is in the words “making proposals or recommendations” – active consultancy which could make the CRA complicit in the issue of the security.

We support it, but we would like to comment further on Provision 1.14 and the proposed 1.14-1

1.14

We consider (existing) Code provision 1.14 (no commitment to a rating prior to the rating assessment) is important. But the second sentence weakens the impact of the first and is unnecessary.

A “prospective” assessment cannot be “the” assessment referred to in the first sentence. A CRA should *not* be committed to a rating indicated in a prospective assessment for any transaction, even for a structured finance transaction. The CRA should be free to respond to external events, changes in the security or its issuer or with regard to other involved parties such as guarantors, parent companies, etc. or in the CRA’s own re-evaluations prior to issuing *any* new rating. For structured ratings, the second sentence undermines this vital principle.

Of course, a CRA must also be free to change an issued rating in response to similar considerations at any time after issue.

1.14-1

We do not consider that a CRA should *as part of its ratings business* “make proposals or recommendations” about the structure of any security or the business underlying it.

We realise that the consultation report is only concerned with structured ratings.

However, were a similar provision to 1.14-1 to be considered in the context of corporate ratings, we think that that would raise some key definitional points.

In rating ordinary corporates, in the course of normal discussion between the company and the ratings analyst, the latter will quite naturally make comments of concern or contentment with aspects of the business or financial structure of the rated firm or aspects of the rated security. This informal education of the issuer is surely a good thing.

The *Code of Standard Practices for Participants in the Credit Rating Process*[5] issued by the ACT and other national treasury associations on the 2003 initiative of the International Group of Treasury Associations includes

> 6.2. The CRA should disclose to the issuer … the key assumptions and fundamental analysis underlying the rating action, as well as any other information that materially influenced the rating action and that could influence future rating actions.

When a corporate issuer is considering a significant change – an acquisition or disposal or significant change to its financial structure, etc. – it may talk informally to the rating analyst about how outlined plans or possible solutions to aspects of them might affect the rating and this will inform its thinking. We regard this as a normal client service and part of the CRAs being open about their methodologies.

If the company plans to go ahead with a change, it will inform the agency in time for to evaluate the change in a revised assessment so that on public announcement the agency is able to make a definitive statement and the market is not left in doubt about the rating of securities and this is part of a normal rating process.

It is vital that none of these activities should be seen as the CRA “making proposals or recommendations” as envisaged in 1.14-1.

If the company wants a full evaluation of the impact of a hypothetical change or range of changes or advice on particular aspects, this would be provided by a ratings advisory business, part of the CRA’s group. The ratings advisory business should be kept separate from the CRA to avoid conflicts of interest, and be separately remunerated. The ratings advisory business can of course also be a source of information for the issuer on how the ratings criteria in use by a firm may need adaptation to a particular type of circumstance and this can inform representations from the issuer to the CRA. Some rating advisory activity is also carried out by some investment banks and others particularly in relation to first-time issuers.

Recommendation 14 (Disclosure of possible “ratings shopping”)

We wonder if this provision is rather anti-competitive. It seems to make it more difficult for a new or expanding agency to have the opportunity for rating competing with established agencies.

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[5] Issued in April 2004 and March 2005 by the ACT (UK), the Association for Financial Professionals (US) and the Association Française des Trésoriers d’Entreprise (France) on the 2003 initiative of the International Group of Treasury Associations. Available (free) in English at http://www.treasurers.org/purchase/customcf/download.cfm?resid=1937.

The language would not translate directly to corporate (or sovereign) ratings, but any similar provision for these categories would surely discourage un-rated issuers beginning to think about taking a rating.

Recommendation 17 (Symbols)

We discussed the general position of symbols above. In that context, this recommendation 17 seems to be too widely drawn.

First, it is clear already that securities of a corporate, sovereign, money market fund, municipal, etc. will each be likely to respond differently to external factors according to the class of issuer they fall in as well as being subject to their own internal factors. Investors are quite familiar with this point.

Secondly, while the broad idea is the same, then, investors would not and should not expect a designation to be applied in quite the same way (or with quite the same implications) to different categories of instrument. CRAs have explicitly recognised this through a subscript to the rating, particularly in regard to money market funds (AAAm). We have urged, above, that this be extended to a further suffix for structured financings.

We think that Recommendation 17 should be modified to accommodate these points.

TREASURY, RISK AND FINANCE PROFESSIONALS ACT

The Association of Corporate Treasurers

The ACT is a body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

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Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf

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SJ – n° 2385/Div.

Ms Kim Allen
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23 April, 2008

Re: AFG (French Asset Management Association)'s comments regarding the IOSCO Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets

Dear Ms. Allen,

The Association Française de la Gestion financière (AFG)[1] would like to thank IOSCO for the work it has been carrying out on Credit Rating Agencies (CRAs) for several years now, and welcomes the opportunity to comment on this latest Consultation Report.

For your information, let us recall that AFG, a member of EFAMA, is also one of the 35 members of the International Investment Funds Association (IIFA) and actively contributes to building a reinforced dialogue between IIFA and IOSCO.

1. General Comments

As users of ratings, on behalf of third party investors, AFG members take particular attention to the current regulatory debate surrounding Credit Rating Agencies (CRAs).

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary financial portfolio managements. Our members include 405 management companies and 673 investment companies. These management companies are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing more than 2500 billion euros in the field of investment management, *making the French collective investment fund industry the leader in Europe* (with nearly 1500 billion euros managed, i.e. 21% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) *and the second at worldwide level after the US*. In the field of collective investment, our industry includes – besides UCITS – the employee savings scheme funds and products such as regulated hedge funds/funds of hedge funds, private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the International Investment Funds Association (IIFA).

Obviously, investment fund managers represented by AFG are responsible for the investment choices they make. But they need to rely on fair information, including ratings.

In our view, several areas probably require improvements, in order to ensure a better understanding of ratings by professional investors:

- The scope of risk covered – or not covered – by the ratings should be made clearer if possible
- A better methodology/symbology, as ratings should not be the same for very different types of financial instruments (e.g. corporate bonds as compared to structured financial instruments)
- Conflicts of interest must be avoided as far as possible, and otherwise clearly disclosed
- Regulators themselves are partly responsible for the over-reliance on ratings, when they introduced many regulatory references to ratings - giving therefore a regulatory status to ratings – without having probably thought enough on the unintended consequences of such regulatory actions. We wish to support here Recommendation 9, last paragraph; of the recent Joint Forum Report on Credit Risk Transfer, which states that "*supervisory authorities should review their use of credit ratings to determine if they need to clarify the distinction between corporate and structured finance ratings.*" More widely, in our view supervisory authorities should review the use of credit ratings in legislations/regulations.

It is difficult to conclude yet on the need, or not, for regulation or further regulation on CRAs. However, as a first step, and considering the recent troubles which surrounded ratings of Structured Finance Instruments (SFIs), we suggest both to reinforce some parts of the IOSCO Code of Conduct on the topics identified right above and to allow regulators for monitoring the compliance of CRAs with this reinforced Code in practice.

2. <u>Specific Comments on IOSCO Consultation Report</u>

a. *Regarding IOSCO Analysis of the role of CRAs in structured finance markets*:

We very widely agree on the analysis provided by IOSCO, in particular:

- the fact that credit ratings played a critical role in the building up of the "credit bubble" that led to the recent market turmoil
- that until recently, ratings did not address market liquidity or volatility risk
- that investors and regulators expect CRAs to take reasonable steps to ensure that the information they use is of sufficient quality to support a credible rating
- that many financial regulators rely on CRA ratings for regulatory purposes

b. *However, a few statements by IOSCO can be more arguable*:

We agree with IOSCO that from a ratings perspective it is not always easy to rate a corporate bond issuer (for which CRAs have to take into account market competition, managerial competence, etc.), while by contrast it seems easier to rate a SFI through underlying cash-flow projections which can be quantitatively modeled. But such an analysis also shows – and it is not so clearly stated by IOSCO - that although the basis taken into account for the two types of ratings is very different, it results in the same symbology –wrongfully for us.

c. *On the specific issue of Transparency and Market Perceptions*:

According to IOSCO, CRAs argue that coming up with a common metric to evaluate the performance of their ratings is not practical or desirable given the differing methodologies they employ. Still according to IOSCO, CRAs state that a common metric would push them towards a common methodology, which would deprive the marketplace of the varying approaches employed today. We support IOSCO conclusion that if the publication of ratings performance data is to have any meaningful use, the CRAs should endeavour to make it transparent and capable of some level of comparison. But we think another conclusion could be drawn: why push for a single symbology if the methods are not common from one CRA to another, and if the methods are not common from one type of security to another[2]? For instance the default rates appeared as different for different types of securities but resulted in the same ratings[3]. Considering the resulting confusion created recently in practice through the

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[2] For instance, two types of discrepancies hit in practice the meaning of ratings currently.

First, according to CRAs themselves, in theory the meaning of a rating is absolute, regardless of the relevant country, financial instrument, etc. E.g. one major CRA wrote in 2004: "*the comparability of these opinions holds regardless of the country of the issuer, industry, asset class or type of fixed-income debt*". Another major CRA wrote in 2007: "*our ratings represent a uniform measure of credit quality globally and across all types of debt instruments. In other words an 'AAA' rated corporate bond should exhibit the same degree of credit quality as an 'AAA' rated securitized issue*".

However, in practice, it appears that the actual behaviour of rated obligators or instruments may turn out to have more heterogeneity across countries, industries and product types (see for instance P. Nickell; W. Perraudin and S. Varotto, 2000, "*Stability of Rating Transitions*", Journal of Banking and Finance, 24, p. 203-227 – for evidence across countries of domicile and industries for corporate bond ratings. See also the Committee on the Global Financial System (CGFS), 2005, "*The Role of Ratings in Structured Finance: Issues and Implications*" – for differences between corporate bonds and structured products).

In particular regarding structured instruments, it appeared in the subprime turmoil that AAA ratings appeared less stable than normally expected for this class of assets, with examples of downgrades of several notches in a day.

Second, the rating agencies differ about what exactly is assessed. Whereas some major CRAs evaluate an obligor's overall capacity to meet its financial obligation, and hence is best through of as an estimate of probability of default, the assessment of another major CRA incorporates some judgement of recovery in the event of loss. The first ones measure what is called "PD" (i.e. Probability of Default") while the last one measures something which is closer to "EL" (i.e. Expected Loss") (see the analysis provided by the Basel Committee on Banking Supervision (BCBS), 1996, "*Amendment to the Capital Accord to Incorporate Market Risks*", Basel Committee Publication n°24).

In the specific case of structured products, one major CRA stated in 2007: "*we base our ratings framework on the likelihood of default rather than expected loss or loss given default. In other words, our ratings at the rated instrument level don't incorporate any analysis or opinion on post-default recovery prospects.*" By contrast, another major CRA incorporates some measure of expected recovery into their structured product ratings.

[3] For instance, according to Charles Calomiris (Henry Kaufman professor of financial institutions at Columbia University) and Joseph Mason (professor of finance at Drexel University), quoting Bloomberg Markets, while corporate bonds rated Baa by a CRA had an average 2.2 per cent default rate over five-year periods from 1983 to 2005, CDOs rated equally Baa by the same CRA had –before the recent crisis – an average five-year default rate of 24 per cent. We consider that delivering the same level of rating in the two cases (considering that the default

use of the same symbology for various types of securities, we would support the use of separate symbologies instead, for instance taking into account stress conditions regarding volatility and liquidity.

d. *On the specific issue of Independence and Avoidance of Conflicts of Interest*:

We agree with IOSCO that CRAs are doing more than rating structured finance securities, namely advising issuers on how to design the trust structures – presenting therefore a potential conflict of interest by nature.

e. *On the specific issue of Competition:*

We think it is probably one of the most difficult issue to solve. On the one hand the principle of enlarging the choice of CRAs is laudable. But on the other hand the wish to set up conditions for the activity of CRAs in issuing ratings limits by nature the number of eligible candidates, as it would make barriers to entry even higher than today.

f. *Regarding the draft modifications introduced in the IOSCO Code of Conduct Fundamentals for CRAs*:

We very widely agree with the amendments introduced by IOSCO in its Code of Conduct.

However, we have wonderings on the following provisions:

- Quality and Integrity of the Rating Process:

  Para. A.1.7-3: we obviously support IOSCO's request that CRAs should refrain from issuing a credit rating when the basis for such a rating would not be robust enough. CRAs must be organised to resist the potential risk of commercial pressure from issuers to get the issuance of a rating.

- CRA Responsibilities to The Investing Public and Issuers:

  - Para. A.3.5 letter b: IOSCO asks that the CRA should disclose <u>whether</u> it uses a separate set of symbols when rating SFIs, and their reasons for doing so or not doing so; the CRA should define and disclose a given rating symbol and apply it in a consistent manner for all types of securities to which that symbol is assigned. We think that having a *separate* set of symbols should be <u>a principle</u> as far as possible – for the reason mentioned above: if methodologies are different, rating symbology must be different as well. In addition, starting from such a principle, IOSCO should ask CRAs to apply a given rating symbol in the same manner, and not only in a "consistent" manner, for all securities to which this symbol is assigned
  - Para. A.3.8 last sentence: we agree on IOSCO intent to facilitate rating performance comparisons between different CRAs. But then in our view it raises the issue of remaining regulatory references to ratings, where the

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rate is clearly not the same in the two cases) might be misleading. *(see FT.com, "Reclaim power from the ratings agencies", 24 August 2007).*

potentially differentiated underlying basis for the ratings – from one CRA to another, or from one type of security to another – is not yet taken into account.

**
*

If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), or Stéphane Janin, Head of International Affairs Division at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr).

Yours sincerely,

Pierre BOLLON

ASSOCIATION FRANCAISE
DES TRESORIERS D'ENTREPRISE

IOSCO
To the attention of Ms. Kim Allen

Paris, April 28, 2008

Dear Ms. Allen

The French Association of Corporate Treasurers (AFTE, Association Française des Trésoriers d'Entreprise) wishes to thank IOSCO for the opportunity to comment on its proposal *IOSCO technical committee consultation report on credit rating agencies*. AFTE is made up of 1,300 members representing the 1,000 largest French firms. It is the oldest association of corporate treasurers in the world, and plays an active role in the works of the *European Associations of Corporate Treasurers* (EACT), which it helped to found.

We would like to begin by saying that AFTE will comment from the point of view of non-financial corporations. Accordingly, we will comment only a few of the consultation's proposals.

Corporate ratings

In general, we consider that corporate ratings by the principal credit rating agencies ("CRAs") have worked well. It is important not to weaken this sector in responding to issues arising in other sectors.

Structured finance ratings symbols

AFTE considers that a simple suffix indicating a structured finance rating is desirable.

The function of credit rating is to provide information. The clearer the information, at reasonable cost, the more valuable the communication becomes. It is important, therefore, that any rating scale used is not over-complicated and is both clear and widely understood.

Comparing ratings between risk types is more dangerous territory.

The different methodologies necessarily used in rating different types of instruments and in subsequent monitoring may mean that the CRAs should clarify externally that a rating of a structured product is going to be qualitatively different from that of a corporate or sovereign security.

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The CRAs may consider appending a suffix for structured finance ratings, e.g. AAAsf, so that investors and other market participants are clearly guided towards reference to the specific approach taken in evaluating the particular type of structured finance. As many types of structured financings can be invented, to try to give more detail in the rating symbol would be to over-complicate the quick guide which the basic symbol represents. A rating agency can publish separate ratings of particular characteristics of a structured security just as some CRAs publish a separate "loss given default" rating to complement corporate default ratings.

Other comments

Unsolicited ratings

AFTE thinks that it is not clear for the investor when a given rating for corporate is unsolicited. AFTE thus estimates that a suffix indicating an unsolicited rating is desirable, for example A**u**, u for unsolicited. For AFTE, it would be a progress to have this symbol.

Recommendation 6

We consider that this recommendation is overly restrictive.

We agree, of course, that the CRA should not, potentially misleadingly, force the rating of a novel instrument into an unsuitable established category of rating. However, why should a CRA be constrained from using a new structure or category of rating to accommodate the novel instrument, provided that it makes it clear what it is doing and publishes its methodology, etc. appropriately per recommendation 13 and elsewhere in the code?

Recommendation 17

It is clear already that securities of a corporate, sovereign, money market fund, municipal, etc. will each be likely to respond differently to external factors as well as being subject to their own internal factors. Investors are quite familiar with this point. While the broad idea is the same, then, investors would not expect a designation to be applied in quite the same way to different categories of instrument. CRAs have explicitly recognized this particularly in regard to money market funds (AAAm). We have urged, above, that this be extended to a further suffix for structured financings.

We think that recommendation 17 should be modified to accommodate these points.

We thank you for your attention to our comments and suggestions.

Sincerely,

Richard Cordero
Managing Director

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General Secretariat
International Organization
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April 24, 2008

Dear Sir or Madam,

the purpose of the consultation document "The role of credit rating agencies in structured finance", dated February 2008, is to seek comments on the conclusions CESR has drawn from its market survey and evidence gathering from S&P, Moody's Investment Services, Fitch Ratings and DBRS. We would like to add our views on the positive and negative aspects of the current self-regulatory regime compared with a possible formal regulatory regime.

The German Association of Rating Analysts and Rating Advisors, Bundesverband der Ratinganalysten und Ratingadvisor e.V. (BdRA), was founded in 1999 for the advancement of the profession of rating analysts and for the promotion of ratings in the financial markets. The association intends to promote rating professions and education, to proliferate the interest of rating analysts in relevant entities, to assure a qualitatively high, internationally recognized quality standard in the rating profession, to promote the public understanding of ratings and to certify rating analysts and rating advisors. BdRA accredited several rating analyst education programs in Germany.

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BdRA

Please let us comment on your four areas of interest:

1. Transparency of methodologies

Transparency of methodologies has always been a cornerstone of the principles of ratings (Grundsätze des Unternehmensratings) which were first published by our association in 1999. Up till now there was never an interest of the above mentioned rating agencies even to consider the principles developed by our association, although leading rating agencies in Germany always adhered to them. While there had been contacts between BdRA and DBRS e.g., Moody's and S&P's never responded to any initiative of our association to discuss any of their methodologies and compare them to common professional standards of the rating industry. Their behavior can be explained by a duopolistic market structure, where to major rating agencies are dominating the rest of the market, which is split among a number of small rating agencies.

In our view transparency of methodologies cannot be measured only by the quantity of texts published on a website of a rating agency. We believe that the websites of the duopolists are even misleading since they provide the public with the impression that their methodologies would be very transparent. In reality, they do not disclose key elements of their methodologies so that it is difficult for any competitor to proof that a competitors' view is more accurate.

We believe that transparency is delivered also by educational measures, which have been taken by German rating agencies. The contribution of our members to rating analyst educational programs and programs designed to help rating advisors to understand the rating methodologies are far more adequate to assure transparency to the addressees of ratings. Unfortunately, the leading duopolists have not been cooperative in this point.

To our disappointment, Moody's and S&P's do not even join an initiative in the International Organization for Standardization (ISO) to develop basic standards for the rating industry. The subprime crisis gave enough proof to the fact that rating systems are related to each other: Rating agencies have to rely on bank internal rating systems and data when evaluating structured products. Therefore basic standards on rating services should be useful to all involved. A lack of standards is at the core of possible misunderstandings between market participants, rating agencies and their analysts.

BdRA

2. Monitoring of ratings and migration

The Society of Investment Professionals in Germany (Deutsche Vereinigung für Finanzanalyse und Asset Management – DVFA) set out to develop standards that would allow an
evaluation of the various rating models. Since ensuring information transparency is the centerpiece of this undertaking, BdRA supported this initiative from start. In 2000, the DVFA established the Rating Standards Committee under the chairmanship of Prof. Dr. Jens Leker (University of Münster). For the development of the Rating Standards, the committee created four expert groups, of which one was led by Dieter Pape WP/StB (URA Unternehmens Ratingagentur AG), who served 9 years as president of our association. BdRA members have participated in and contributed to all groups. The committee also includes representatives of various rating agencies, with exception of Moody's and S&P's, banks, investment firms, audit companies, consulting firms and universities. In 2001, the committee published its initial results in the form of the DVFA Rating Standards (FinanzBetrieb, 2001, Issue 4).

Although translated into English language, Moody's and S&P's never referred to nor commented on the "DVFA-Rating Standards and DVFA-Validation Standards" (No. 04/06_e DVFA-Financial Papers). This is hardly understandable since DVFA and BdRA are by far the leading societies in this domain in Germany. Therefore, lots of questions on monitoring of ratings and ratings migration are left open as far as ratings provided by the duopolists are concerned.

3. Human resources

For nearly a decade BdRA strived for assuring best qualification and education of rating analysts. Various renown universities are providing high-level rating analyst education programs which lead to the title "Certified Rating Analyst", recognized by our association. Senior analysts from all major rating agencies were invited to contribute to these educational efforts. Only in a few cases Moody's and S&P's used those initiatives as a marketing and recruiting platform.

S&P's announced that it will be partnering with an academic institution to develop its own exclusive analyst certification program. By designing their proprietary program S&P's derails endeavors to create a better understanding of the uses, meanings and criteria of credit ratings among all market participants concerned.

BdRA

4. Conflicts of interest

The German association of rating analysts and rating advisors has always underlined the importance of separating analytical functions at a rating agency which lead to a published rating and advisory functions at consulting companies, although both make use of the same knowledge base sometimes. Our members noticed a tendency at Moody's and S&P's to extend their value added chain to services which formerly were the domain of the media or rating advisors.

In their search for growth opportunities Moody's and S&P's do not refrain from related businesses, therefore enhancing the probability that managing potential conflicts of interests within their organizations becomes too complicated.

Kind regards,

BdRA
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und Ratingadvisor e.V.

Bundesverband Investment
und Asset Management e.V.

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April 25, 2008

Ms. Kim Allen
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per Email: k.allen@iosco.org

Comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

Dear Ms Allen,

BVI[1] gladly takes the opportunity to comment on IOSCO consultation report on the subject of Credit Rating Agencies.

Overall, we agree with the findings and recommendations of the consultation report and would like to add the following comments to your draft changes of the Code:

Quality and Integrity of the Rating Process

Ad No. 1 and 8

We assent to IOSCO's view that the objective monitoring of structured finance (SF) products presents challenges and sufficient resources, including separate analytical teams, are necessary. Our members believe that CRAs could allocate more resources to the monitoring of rated deals, even though the situation in terms of the timely issuance of monitoring reports and rating actions has recently improved. Nevertheless, there is still a perceived need for more accurately timed monitoring of deals.

Some of our members also question the timing of some of the recent mass rating changes. Sometimes CRAs seem to be late or at least reluctant to

[1] BVI Bundesverband Investment und Asset Management e.V. represents the interest of the German investment fund and asset management industry. Its 88 members manage currently assets close to EUR 1.7 trillion both in mutual funds and mandates. For more information, please visit www.bvi.de.

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change ratings. The analysis of available information often allows for early detection of signs of emerging pool credit quality deterioration or improvement as the case may be. For example, SF deals with in line performing assets and significantly improved credit enhancement do not usually get an upgrade on a timely basis. Hence, CRAs should improve the rate of deal-specific rating actions versus mass rating changes.

Ad No. 2

We agree with the proposal to establish an independent methodology review and change function within a CRA. Rating changes which are driven solely by changes of methodology should be viewed with extreme care in order to avoid market disruptions because of sell-off pressure for institutional investors who are bound by rating-based investment guidelines. A case in point is the proposed change in CDO rating methodology by Fitch. According to market experts, this methodology change if implemented could lead to a sell-off pressure as high as Euro 150 billion.

In order to avoid “artificial” market interruptions, CRA’s should consider appropriate rating actions including, but not limited to, grandfathering existing transactions against purely methodology-driven rating changes.

CRA Independence and Avoidance of Conflicts of Interest

Ad No. 11

Disclosure of the sources of CRA fee income is in our view necessary in order to mitigate potential conflicts of interest. Some of our members would like to receive information on whether any issuer, originator, arranger, subscriber or other client and its affiliate make up more than **5** percent of the CRA’s annual revenue. In any case, disclosure shouldn't be limited to yearly reports, but also be part of all presale reports of the CRA. Furthermore, a general change of the CRA compensation model from an upfront to an ongoing payment, depending on performance and volatility of the ratings, needs to be explored further in the future.

Ad No. 12

We entirely share IOSCO’s view that the CRA’s should disclose in better terms what they consider to be ancillary business. In particular S&P needs to disclose and explain how it achieves a strict separation of the core ratings business from other or ancillary businesses such as provision and marketing of US ISINs. In this specific area the market still perceives a lack of separation in the different business lines, e.g. on the S&P website, because all activities take place under the same brand without explicit clarification which (legal) entities perform the core rating and ancillary services respectively. This raises concerns that the client credit rating may be impaired if ancillary services such as US ISIN licences are not subscribed to.

CRA Responsibilities to the Investing Public and Issuers

Ad No. 13

CRAs should take ongoing efforts to ensure clear communication of the central characteristics and limitations, especially pertaining to structured finance products ratings. By the same token, however, it is clear that CRAs only have limited means to educate or influence the understanding of other market participants with respect to the meaning of SF ratings.

Ad No. 14

In order to further discourage "rating shopping", the following practice should be considered. In SF deals there is a tendency that SF ratings by several CRAs are made available to the public only on the highly rated senior tranches. Lower ratings on junior tranches will be usually only made public by one CRA. This is the result of the issuer's/arranging bank's contractual right to suppress the publication of ratings they do not deem necessary (rating shopping). Investors, however, would be much better equipped to assess the true risks of a specific deal if they were able to analyze all ratings assigned to a specific deal. The different analytical focus of the three CRAs tends to be more obvious in the ratings and analysis of the higher risk bearing junior tranches of a SF deal. Going forward, CRAs should be obliged to provide in their SF rating contracts that the ratings on all tranches of a SF deal will be disclosed in order to prevent "cherry picking" by the issuer/arranging bank and improve information available to the market place.

Ad No. 15

Disclosure of performance of a CRA's ratings should be extended to the disclosure of volatility of ratings and should provide for a differentiation between asset classes.

Ad No. 16

We agree that a greater level of information on rating performance and SF cash flow attributes is necessary. Structurally, disclosure of information on structured finance deals does not take place on equal terms to all parties involved in the deal. CRAs and equity-tranche-investors usually get more and earlier information than other investors. Our members would like to get access to more detailed regular information, especially to the "issuer reports" or "trustee reports" which the CRAs receive. Currently our members have access only to the regular CRA investor report on a deal. It seems odd that investors who bear the financial risk receive less information than the CRA. Press releases and ratings listings are usually available to the public for a sufficient time while in-depth research and monitoring reports on single issue(r)s are limited to registered and paying subscribers. Monitoring data should not be provided on a separate web platform and access to the data should not require extra payments to the CRA. A monitoring sheet on each rated deal should be made available, e.g. as is practice with Moody's. That sheet should include information on the performance of the asset pool relative to the base case. The quality of the monitoring reports will be sufficient if the information discussed above is added.

It should also be considered to require CRAs in the rating contract with issuers to assign a SF rating to a specific deal only if a standard set of minimum disclosure criteria can be provided by the CRA in the investor reports. This minimum after-sales transparency should be a sine qua non condition to assign/maintain a rating even if there is no change in the credit quality of the transaction.

Ad No. 18

In general, our members consider the access to and availability of structured finance ratings, including the transparency of methodologies, and changes thereto, satisfactory. However, not all information is publicly available to all investors. We agree on the need for improved disclosure of key model assumptions, weightings of key parameters and correlations as well as the effect of changes in assumptions and correlations in order to allow a proper judgement on the impact of market changes on ratings volatility. CRA's should make available the base case/expectations and assumptions on which the rating is based, e.g. the distribution (mean, sigma) of expected defaults in the asset pool over time. Stress cases should be added as well as a comparison of the base case of the deal to the behaviour of the SF subsector in the region. To the extent that a CRA needs to rely on another CRA's rating, e.g. the rating of an underlying ABS in the rating of a CDO, all CRA's should be required to base any "notching down" policy of third party CRA ratings on objective criteria only, in particular on the loss performance of the deal. In this way competition between rating agencies could be strengthened.

All this information has to be included in the pre-sale report in order to provide sufficient transparency for investors on the basis of the rating prior to buying the security.

Overall, our members still have a preference for the current system. The IOSCO Code of Conduct for CRAs will deal appropriately with the risks in ratings of structured finance, if the rules are improved as described in our response above. Still, IOSCO should continue to monitor and demand the adherence of the CRAs to the Code of Conduct. This may be backed up by the provision of an independent CRA ombudsman. Some of our members, however, doubt that self-regulation of CRA's is sufficient. The jurisdictions in which the CRA's operate could opt in their laws and regulations to enforce compliance with the CoC.

We hope you will find our comments helpful and remain at your disposal for any questions that may arise. Our response can be made public.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

Rudolf Siebel, LL.M
Managing Director

Marcus Mecklenburg
Director

CFA INSTITUTE | Centre for Financial Market Integrity

Ms. Kim Allen,
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

London, 24th April 2008

Dear Ms. Allen,

Letter of 'Public Comment' responding to
"IOSCO Technical Committee Consultation Report on Credit Rating Agencies"

The CFA Institute Centre for Financial Market Integrity ("Centre") welcomes the opportunity to comment on the International Organization of Securities Commissioners ("IOSCO") Consultation Paper – "IOSCO Technical Committee Consultation Report on Credit Rating Agencies" (the "Consultation"). We confirm that our comments may be made available to the public.

We feel that the consultation correctly analyses the role of credit rating agencies in structured finance markets. However, we are concerned that the ratings agencies relied too heavily on, and neglected to disclose the limitations of, their statistical analyses. We observe that many fixed-income portfolios are credit constrained and that the fiduciaries and regulators who set these constraints may not fully appreciate that a credit rating speaks to the probability of default and not to such issues as liquidity and volatility. This comment develops upon the consultation's remarks concerning the CRAs' activities in the shaping of structured products and the association made by some market participants that the eventual rating was a "seal of approval". We feel that the CRAs could have done more to dispel this myth through greater disclosure of their assumptions specifically about correlations.

In view of the points above, we strongly recommend that IOSCO, through the revised 'Code,' require CRAs to differentiate the nomenclature of structured products from traditional corporate bonds. The new provision in the Code makes this optional. We see a change in nomenclature as a vital part of the process to recognizing the differences between these different types of fixed-income instruments and help restore confidence to the credit markets and credit ratings business.

We are supportive of IOSCO's proposed revision of the 'Code of Conduct Fundamental for Credit Rating Agencies'. However, in a number of instances we would push for firmer measures. We highlight our belief that IOSCO should create a new principle asking CRAs to refrain from publishing ratings where they lack robust data and/or methodologies.

Our suggested improvements are based on a review of the Code earlier this year during which we considered possible ways to help make the ratings process more effective and enhance market perception of the ratings issued. In organising our suggestions, we drew on the collective experience and ideas of our 'Capital Markets Policy Council', a global voluntary group of market practitioners, who provide practical expertise and industry

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perspective to our advocacy work. Below is a list of some of the additional suggested reforms for CRAs that came from our review and analysis[1]:

- To use a rating nomenclature/categorization that distinguishes structured products from both corporate and commercial paper ratings to help investors recognize the differences.

- To refine or otherwise eliminate the concept of "investment grade" wherever possible to reduce the incidence of misconception about the purpose of the CRA's ratings.

- To encourage a global best practice of prohibiting "notching," where a CRA unilaterally issues a rating on an entity or structure that was not sought by the issuer.

- To create an executive-level compliance officer position at CRAs to ensure implementation and enforcement of the IOSCO code.

- To require complete adoption of the IOSCO code to claim compliance.

- To call on CRAs to refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating.

I attach our response that addresses the questions of the consultation paper. Please do not hesitate to contact me, should you wish to discuss any of the points raised in our response.

Yours faithfully,

C Cronin

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[1] The full press release is found at this link http://www.cfainstitute.org/aboutus/press/release/08releases/20080205_02.html

The Centre[2] is part of CFA Institute[3]. With headquarters in Charlottesville, VA, and with offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of approximately 95,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom more than 82,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

Your paper, published for information and comment, seeks comment on two statements.

1. Whether the paper correctly analyzes the role of credit rating agencies in structured finance markets.

2. To the proposed recommendations for modifying the IOSCO Code of Conduct Fundamental for Credit Rating Agencies.

Our detailed comments to these statements are set out below.

1. Whether the paper correctly analyzes the role of credit rating agencies in structured finance markets.

We concur with IOSCO's analysis of the role credit rating agencies play in structured finance markets. We highlight the following points that;

- The purpose of a credit rating is an opinion on either the likelihood of default or the potential for principal loss; it does not address market liquidity or volatility risk.

- The use of the term 'investment grade' causes confusion and we would discourage market participants using this term with respect to credit ratings.

- A CRA's opinion on the loss characteristics of a security is occasionally viewed by some market participants as a "seal of approval" on the investment, because in many respects the CRA controls the profile of the structure.

- With regards to methodologies we would go further and suggest that the CRAs should conduct their own relevance and reliability tests on the robustness of their

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[2] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

[3] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

methodologies and assumptions, for example in the case of default, recovery rates and correlations.[4]

- CRAs should 'fully' disclose the assumptions underlying their methodologies. We feel that in a highly concentrated market of CRAs that these assumptions should be free to view to enable investors to compare these important high-level inputs with their own expectations.

- Fixed-income portfolios are commonly asset constrained by a minimum credit-quality threshold. Whilst we agree that a credit rating speaks to the probability of default or likelihood of capital loss, trustees and other fiduciaries that set these portfolio constraints may not understand credit ratings in these terms. We have anecdotal evidence that customers pushed managers towards these structured vehicles because they offered higher returns than traditional corporate bonds. This behaviour is consistent with a manager selection process that is dominated by past performance.

- In view of the points above, which raise our concerns that a) the underlying methodologies 'may' have fundamental flaws, b) that assumptions 'may' push the bounds of mean-reverting behaviour, and c) that fund managers must respect the wishes of their clients, it is the Centre's view that using the same nomenclature for structured products as traditional corporate bonds can create a "seal of approval" that leads to investor confusion. Therefore, we strongly recommend that CRAs should assign different rating terms and symbols for structured products.

2. To the proposed recommendations for modifying the IOSCO Code of Conduct Fundamental for Credit Rating Agencies.

We are supportive of IOSCO's proposed revision of the Code of Conduct Fundamentals for Credit Rating Agencies. However, in a number of instances we would push for firmer measures.

I. As mentioned above we are concerned that the CRAs have pushed the credibility of the mathematics behind their methodologies. Therefore, we urge that IOSCO include a new principle in the 'Quality and Integrity of the Rating Process' section of the Principles for the Activities of Credit Rating Agencies to assert better business practice:

> *"CRAs should refrain from publishing ratings where they lack robust data and/or methodologies."*

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[4] To quote Arturo Cifuentes of R.W. Pressprich & Co: "The three drivers in modelling CDOs are the probability of default, the recovery rate, and correlation of the underlying pool of credits. In general, the probability of default is by far the most relevant factor and correlation, the least. Unfortunately, an unwarranted amount of attention is currently given to correlation. Worst yet, most models are driven by (or based on) asset correlation assumptions when what is really relevant is the default correlation… Also keep in mind that a fair amount of what passes for sophisticated mathematical modelling (when it comes to this not-so-relevant variable) is often of very dubious legitimacy".

II. Returning to the ‘Code of Conduct’, we believe that due to modelling problems and associated “seal of approval” issues that CRAs must distinguish between traditional corporate bonds and structured products by using a different rating nomenclature. Whilst paragraph 3.5b, which discusses separate symbol disclosure on structured products is a step in the right direction, it offers CRAs a choice on whether to use a different nomenclature or not. This option has always been available to the CRAs, but to date has never been used on structured products, though now subject to discussion by the CRAs. Creating the provision will not drive change where the option has always been available. Hence we see a change in nomenclature as a vital part of the process in return confidence to the credit markets and credit ratings business.

III. Code 2.5 which requests that a CRA separate its credit rating business from any other business, now requests that a CRA define what it considers and does not consider to be ancillary to its primary credit rating business. We are of the opinion that CRAs should not provide consulting or advisory services, to make a clean break from this potential business conflict.

IV. We support the new code 2.17, the ‘look-back’ provision, which reviews the ratings of former employees who join an issuer or investment bank that the CRA currently or previously has rated. While we recognize that most rating agencies use rating committees to limit the influence of a single analyst, we believe these reviews are particularly important to ensure investor confidence. We also believe that these reviews should be extended to include instruments that have endured multi-step downgrades within a short period of time, such as three months. In either case, we suggest that the CRA should alert both regulators and investors about the outcome of such reviews.

V. We support the new code 1.9-1, the provision that seeks to separate analytical teams into those that do the initial rating and those that subsequently monitor the rating. We would add that the members of these teams should go through periodic rotation, as a way of preventing abuses, or uncovering faulty ratings. This rotation of the rating teams will provide further oversight and management of potential conflicts of interest.

VI. We would add in section B, ‘Monitoring and Updating,’ a code that CRAs should require analysts to participate in continuing education programmes on credit analysis, methodologies, and CRA policies and procedures.

VII. Code 3.3 is amended to include public disclosure of methodology; this is a positive step. However we urge that CRAs should also disclose the ‘assumptions’ incorporated into these methodologies as part of this provision.

VIII. We support new code 3.5c that seeks to increase public understanding of the rating process through increased disclosure. While we urge IOSCO to require CRAs to implement the Code in its entirety to claim compliance, we suggest that CRAs quantify the degree of compliance to this disclosure requirement if a comply-or-explain structure is retained.

IX. An idea not discussed in this consultation, which we feel should be in the code, is that CRAs should cooperate to establish a centralized repository for ratings performance studies that is available to investors. The purpose of such a repository would be to allow easier market comparison among CRAs. This repository should be funded in such a manner by CRAs that will allow it to conduct its own 'public' studies into CRA performance free of interference by the CRAs.

24th April 2008

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April 25, 2008

Via Electronic Mail

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Re: Response to Request for Comment: "IOSCO Technical Committee Consultation Report on Credit Rating Agencies"

Dear Ms. Allen:

The Commercial Mortgage Securities Association (CMSA) submits this letter in response to IOSCO's request for comment on the Consultation Report on the Role of Credit Agencies in Structured Financial Markets (the "Report"), issued by the IOSCO Technical Committee in March 2008.

CMSA is a global trade organization with its primary mission being to promote the ongoing strength, liquidity and viability of commercial real estate capital market finance worldwide. Based in New York, with a government relations office in Washington, DC, as well as a strong presence in Canada, Europe and Japan, CMSA is the collective voice for the entire market, with a diverse global membership of over 400 member firms represented by more than 5,000 individuals who actively engage in commercial real estate capital market finance activities. These members embody the full spectrum of the commercial mortgage-backed securities (CMBS) market, including senior executives at the largest banks and investment banks, insurance companies, investors such as money managers and specialty finance companies, servicers, other service providers to the industry, and the rating agencies, including DBRS, Fitch Ratings, Moody's, and Standard & Poor's. CMSA and its members are the leaders in setting standards and maintaining a favorable investing environment for the more than $900 Billion in outstanding CMBS issuance in the United States, and we submit these comments in an effort to further advance these dual objectives.

In the Report, the IOSCO CRA Task Force makes a number of recommendations for modifying the IOSCO CRA Code of Conduct. As a preliminary matter, we would like to commend the Task Force for not requiring that structured finance products be rated on a different scale from corporate and municipal bonds. Having said that, CMSA is concerned about Recommendation 17 of the proposal which states that –

> A CRA should disclose whether it uses a separate set of rating symbols for rating structured finance products, and its reasoning for doing so or not doing so. In any case, a CRA should clearly define a given rating symbol and apply it in the same manner for all types of products to which the symbol is assigned.

For the reasons outlined below, CMSA does not believe that credit rating agencies ("CRAs") should have to justify rating structured finance vehicles in the same manner as corporate or municipal bonds. Such a requirement would not only be unnecessarily burdensome, it could have the same effect as a specific requirement that separate ratings be used. That is, because of the stigma it attaches to the use of a single set of rating symbols by a CRA, such a disclosure requirement could result in separate rating schemes becoming a de facto rule or best practice in the industry to the detriment of the capital finance markets and the borrowers for which those markets provide liquidity.

For many years, the credit rating agencies have maintained that like ratings are comparable across asset classes because, fundamentally, the underlying assessment is the same regardless of asset class – the likelihood that the bond obligations will be repaid in accordance with their terms. Use of a separate rating structure for structured finance products would be inconsistent with this longstanding principle and create significant confusion for the investors in all of the capital markets. Although we agree with assertions by some that structured securities in the commercial sector have exhibited collectively stronger performance than similarly rated corporate securities, we are concerned about the impact that certain changes to the ratings classifications could have at this time. Accordingly, CMSA strongly believes that a separate ratings scale could make the structured products market even more volatile by adding to investor confusion, and such action should be avoided. Moreover, investors would be forced to revise their investment policies to incorporate the new rating structure, develop a new analytical and monitoring infrastructure to interpret the new ratings, and determine whether they need to have a specific investment allocation for each asset class. Additionally, regulatory capital requirements of Basel II are based upon the current rating methodology - so any rating changes would require a change to Basel II for bank investors. Unfortunately, these unintended consequences would increase costs for investors and further erode liquidity that is critical to the extension of credit for borrowers.

CMSA has consistently opposed attempts to directly impose requirements for separate ratings for structured finance, and the "back door" implementation of such a policy by requiring disclosure of the rationale for not creating a separate rating structure or structures for structured finance products is equally problematic. Enclosed is a copy of a letter that we wish to submit for your record on this issue on behalf of several associations that represent a broad spectrum of professionals active in both the primary and secondary real estate and non-real estate asset-backed finance markets.

As an alternative to requiring that CRAs "justify" their decisions regarding rating symbols in disclosure, CMSA members, including investors, issuers and other CMBS market participants, would welcome the CRAs' issuance of additional analysis about the potential risk characteristics of rated bond loan pools, as well as additional and targeted transparency related to the underlying rating methodology that is being employed in determining rating assessments. Our current recommendations are below. As an introductory comment, though, we note that our suggestions are intended to build upon rather than replace any disclosures the rating agencies currently are providing.

With that in mind, our specific recommendations are as follows –

- *Methodology*. CMSA encourages CRAs to publish and update on an as needed basis[1] –
  - Their policies and procedures related to CMBS valuations that are more specific than those currently published;
  - A clear guide to their model methodology, including specific guidance regarding the weighting of various inputs;
  - When model methodology is modified or updated, an explanation of the impact of that modification or update on existing deal ratings, if any; and
  - An explanation of their internal committee processes, including any modifications to governance procedures that have recently been, or will be, instituted.
- *Pre-Sale Reports*. CMSA suggests that CRAs should not solicit or receive outside editorial comments on their pre-sale reports and adopt a standard pre-sale report template. This template could change over time but should include items such as –
  - Reference to published documents with their latest methodology that can be found on their websites.
  - A discussion of at least the largest 10 loans with an explanation of the material underwriting assumptions for those loans and an outline of any material assumptions in performance, both positive and negative.
  - A discussion of the material strengths and material concerns on the deal and at loan level in the Strengths and Concerns section that will point to the heart of an issue. For example, is it a strength if 1% of a deal is shadow rated or is it a concern if 22% of the pool is office properties?
  - A conduit analysis that compares the proposed transaction to the average rated deal over a rolling time frame; and
  - Although we understand the current rating methodologies of shadow rated loans, it would be beneficial to include more detail around the CRA's underwriting and valuation assumptions (e.g., their cap rates, vacancies, base rents, etc.).

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[1] We note that it appears that all of this information – and more – is required to be disclosed under the regulations issued by the United States Securities and Exchange Commission in June, 2007. *See* 17 CFR § 240.17g-2(a)(6) (requiring a registered "Nationally Recognized Statistical Rating Organization" to maintain a publicly available "record documenting the established procedures and methodologies used by the nationally recognized statistical rating organization to determine credit ratings.") *See also* SEC Form NRSRO, Instructions for Exhibit 2 (the requisite "description of the procedures and methodologies used in determining credit ratings" which is required to be "sufficiently detailed" including, among other things, "the quantitative and qualitative models and metrics used to determine credit ratings").

- *Surveillance Press Releases.* CMSA acknowledges that CRAs typically provide standard press releases but CMSA believes that frequent communication is more important now than ever before. We suggest that all rating agencies adopt a standard surveillance press release that would include, among other items, a discussion of why a deal was upgraded or downgraded; the current percentage that have defeased; any loss estimates; any weakness in the largest 10 loans; information on the "shadow rated" loans included in the deal, including the current rating for each in order to compare ratings with those in the pre-sale report; and an explanation of the impact, if any, of changes in the "shadow rated" loans ratings on the deal ratings, particularly when the shadow rated loan rates fall from investment grade to below investment grade.

Ultimately, CMSA believes that new and targeted disclosure will benefit all of the CMBS market participants. We appreciate the opportunity to comment on this proposal and look forward to working with IOSCO and the credit rating agencies to help accomplish that goal. Please do not hesitate to contact us with questions and comments.

Sincerely,

Dottie Cunningham
Chief Executive Officer
Commercial Mortgage Securities Association

Enclosure

The Real Estate Roundtable
Mortgage Bankers Association
Commercial Mortgage Securities Association
NATIONAL ASSOCIATION OF REALTORS®

April 21, 2008

Dear Chairman Dodd and Ranking Member Shelby:

The above signed associations are writing to express our concern with and opposition to proposals to differentiate between credit ratings for structured finance products and other asset classes, such as corporate and municipal bonds. Collectively, these associations represent a broad spectrum of commercial and multifamily real estate borrowers, investors and professionals active in both the primary and secondary real estate and non-real estate asset-backed finance markets that employ more than one million professionals and serve millions of Americans. We urge caution to ensure that any change to the ratings' composition for structured securities does not negatively impact borrowers, investors and the $25 trillion, non-Treasury, debt capital market.

Specifically, this letter is in response to the *Policy Statement on Financial Market Developments* issued in March 2008 by the President's Working Group of Financial Markets that calls for "…changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities."

We are concerned that differentiating structured asset-backed bonds from corporate and municipal bonds will serve to further undermine, rather than restore, liquidity that is a key factor in a borrower's access to credit – from cars and student loans, to homes and commercial real estate, and beyond. As Moody's recently noted in a request for comment related to this issue, "… credit ratings are forward-looking opinions that address just one characteristic of fixed income obligations – an assessment of the likelihood such obligations will be repaid in accordance with their terms." We agree with this evaluation of the definitional scope of a rating and would discourage any departure from this concept.

We believe educating investors about the inherent risk factors associated with all categories of securities (both structured and non-structured) would garner greater long-term liquidity than isolating structured securities for a separate rating scale in such a broad and simplistic manner. This approach would address, in a much more appropriate and comprehensive manner, the risk factors associated with each category of securities. Accordingly, we strongly believe replacing or modifying the existing ratings scale would contribute to greater market volatility and investor confusion, which must be considered and avoided. Moreover, such a change would require investors to revise their investment policies to incorporate any new rating structures and develop new analytical and monitoring infrastructure to interpret the new ratings. Additionally, regulatory capital requirements of Basel II are based upon the current rating methodology - so any rating changes would require a change to Basel II for bank investors. Unfortunately, these unintended consequences would increase costs for investors and further erode liquidity that is critical to the extension of credit for borrowers.

For these reasons, we consider the proposal to differentiate ratings to be counter-productive and urge careful deliberation given the fragile state of our markets and the feedback from thousands of investors, borrowers and other market participants we collectively represent. We believe the ultimate result would be to further erode investor confidence and further weaken our economy's stability. We welcome the opportunity to discuss these issues further and look forward to working with you on these important issues.

Sincerely,

The Real Estate Roundtable
Mortgage Bankers Association
Commercial Mortgage Securities Association
NATIONAL ASSOCIATION OF REALTORS®

-----Original Message-----
From:
Sent: Tuesday, April 15, 2008 10:09 AM
To: Greg Tanzer
Subject: Fw: Rating Agencies

----- Original Message -----

From: guido.costa@alice.it [mailto:guido.costa@alice.it]
Sent: Monday, 14 April 2008 17:28
To: FSForum, Service
Subject: Rating Agencies

Dear Sirs,

The 7 April Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience highlights the long dated conflict of interest deriving from the issuer-pays model and the widespread habit for CRAs to be paid only if the credit rating is issued.

IOSCO is therefore entrusted with the responsibility to address CRAs' conflicts of interest.

In order to make IOSCO's action more effective a suggestion could be to enforce a measure stating that:

* a percentage of the Rating Agencies’ remuneration should be paid by means of securities of the issuer;
* such percentage should be directly proportional to the rating assigned (the higher the rating, the higher the percentage; e.g. AAA-> 10.0%; AA-> 7.5%.....);
* such securities should be held by the Rating Agencies for a minimum period of time and only progressively be disposed of (e.g. 25% per year starting from the date of each bonds issue).

Provided the Rating Agencies trust their own recommendations, they could not object this regulation.

The above-mentioned percentages (AAA-> 10.0%; AA-> 7.5%.....) are purely indicative. In order for the regulation to be effective, the amount to be paid in securities would have to be set at the minimum level required to induce a quality enhancement of the rating methodology processes, without causing the CRAs a liquidity crunch. In this regard, however, considering that - as the Report underlines - "some regulations also implicitly assume that securities with high credit ratings are liquid and have lower price volatility", the greater reliability of the rating process would contribute to make the securities portfolio of each CRA a strong back up for credit to be obtained, if required, from the banking system.

Best regards.

Guido Costa

Joint Response to the Technical Committee of the International Organization of Securities Commissions' Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets

from

A.M. Best Company, Inc.
DBRS Limited
Fitch, Inc.
Moody's Investors Service, Inc.
Standard & Poor's Rating Services

April 25, 2008

Ms. Kim Allen
IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain

Re: Response to the Technical Committee of the International Organization of Securities Commissions ("IOSCO") on its Consultation Report on the Role of Credit Rating Agencies ("CRAs") in Structured Finance Markets

INTRODUCTION

This response is submitted on behalf of A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc.; Moody's Investors Service, Inc.; and Standard & Poor's Rating Services (the "**Participating CRAs**"[1]). We thank the Technical Committee of IOSCO and its Credit Rating Agencies Task Force ("**CRA Task Force**") for the opportunity to provide our views on the Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets ("**Consultation Report**"). The Consultation Report includes proposed amendments to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies ("**IOSCO Code**"), which was first issued in December 2004.

We reaffirm our commitment to the IOSCO Code and its underlying principles regarding the quality and integrity of the rating process, managing potential conflicts of interest, and CRA transparency to the investing public and issuers. As the CRA Task Force and Technical Committee are aware, each Participating CRA has adopted a code of conduct that is modeled on the existing IOSCO Code. Once the recommendations in the Consultation Report are finalized, the Participating CRAs intend to move swiftly to amend their respective codes of conduct, as appropriate, and adopt other necessary changes based upon the final recommendations of policy-making bodies. In addition, at the request of authorities and market participants, the Participating CRAs have been working together to develop proposals to enhance CRA performance and confidence in the credit rating process. In this regard, the Participating CRAs are committed to implementing on a timely basis the proposals we have developed to enhance investor and regulatory confidence in our credit rating opinions and the credit rating process.[2]

The Participating CRAs do not object to the majority of the proposed changes to the IOSCO Code. There are, however, two proposed changes that we believe need further

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1 Each Participating CRA is registered with the U.S. Securities and Exchange Commission ("**SEC**") as a Nationally Recognized Statistical Rating Organization ("**NRSRO**").

2 While each Participating CRA is likely to have a different implementation schedule, we expect that a number of changes will occur in 2008. In the meantime, we have individually started to implement changes and each Participating CRA has been working to enhance its own policies, processes, methodologies and reports, as appropriate.

substantial modification. The first, proposed Provision 1.7, could be read to impose on CRAs a new due diligence or data verification duty that is fundamentally at odds with the role CRAs play in securities markets. The second, proposed Provision 2.8c, is unworkable in its current form and would not eliminate the problem of rating shopping. We discuss each in turn below. We also cover in Annex I important matters of a more technical nature.

In addition, we have summarized in Annex II the measures we are committed to implementing on an industry-wide basis. These measures include the proposals we have developed, with valuable feedback from authorities and industry groups.

I. Proposed Change to Provision 1.7 Should Be Modified to Make It More Consistent with the Role of Credit Rating Agencies

The Task Force has proposed that Provision 1.7 be amended to include a recommendation that *"The CRA should adopt reasonable measures to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating."* We believe the purpose of this provision is generally consistent with measures that each of us is implementing regarding the quality of information we receive.[3] We are concerned, however, that the language as drafted could be interpreted by others as meaning that CRAs should be responsible for somehow guaranteeing the quality of that information. Such an obligation would be not only infeasible, but also inconsistent with CRAs' role in the financial markets. Moreover, given the hundreds of thousands of ratings we assign globally, placing a verification obligation on credit rating agencies would be both overly burdensome and redundant. Others in the market are already responsible for certifying to the accuracy of the data and are better positioned to do so. Accordingly, as discussed below, we believe the language should be modified to clarify the scope of the new proposal so that it comports with the role and function of CRAs in the capital market.

Credit ratings are opinions about uncertain future events and represent a CRA's view of relative credit risk based on information each CRA believes at the time of issuing the rating to be dependable. In this regard, the Participating CRAs have adopted provisions in our own codes of conduct to implement existing Provisions 1.1, 1.4 and 1.6 of the IOSCO Code calling upon CRAs to:

- adopt, implement and enforce written procedures to ensure that our opinions are based on a thorough analysis of all information known to us that is relevant to our analysis in accordance with our published methodologies;
- assign ratings that reflect all information known and believed to be relevant to our analysis; and
- take steps to avoid issuing rating analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.

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[3] Each Participating CRA is putting in place mechanisms and processes to further this objective.

The measures described above are consistent with our function as CRAs. On a practical level, the implementation of these provisions means that when rating a corporate issuer we receive audited financial data and regulatory filings, and when rating a structured finance product, the originator and/or sponsor of the structured product makes representations and warranties to the other parties to the transaction as to the quality of the loan level data describing the collateral. As part of the credit rating process, we consider, among other factors: a) the source of the data we receive; b) the track record of that source in providing quality data; c) the predictive powers associated with any one piece of data;[4] and d) whether or not the data (such as financial information) has been subject to review by a third party.

In light of recent market difficulties, however, each of the participating CRAs is considering additional measures regarding the quality of data used in the rating process. In this respect, we support the purpose of the proposed revision to Provision 1.7. We believe that purpose is also consistent with the recommendations of the Financial Stability Forum ("**FSF**") regarding this subject.[5]

While we agree that the underlying premise of the proposed revision is appropriate, we are concerned that as drafted the proposed language may be interpreted by others as creating an affirmative duty on CRAs to verify first-hand the information provided to us. Specifically, because the current proposal calls upon CRAs to adopt "*reasonable measures to ensure the quality*" of the information they rely on in the rating process, we are concerned that 1.7 as drafted could be interpreted as creating a new "due diligence duty" by placing a data verification obligation on CRAs, rather than on other, more appropriate, parties. We believe that this obligation should remain with the entities that have the first-hand knowledge of the information and the expertise to verify it: the issuers of corporate securities and originators of structured products.

Accordingly, to make Provision 1.7 consistent with the role of CRAs in the financial markets, we suggest that the proposed Provision be modified as follows:

> *1.7 … The CRA should adopt reasonable measures ~~to ensure that~~ regarding the sufficiency of the quality of the information it uses ~~in assigning a rating~~ ~~is of sufficient quality~~ to support ~~a~~ credible ratings. If the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the CRA should identify, in a prominent place, any limitations in the ratings of such products.*

To clarify that the intent of Provision 1.7 is to encourage CRAs to consider the quality of the information used in the rating process without expecting them to perform first-hand

4 For example, historically, FICO credit scores were considered a strong indicator of a mortgage borrower's financial capability.

5 See Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (April 2008) at pp. 36-37 and 58-59. Recommendation IV.6 states that "CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products." Among other things, the FSF also has recommended that CRAs require underwriters to provide representations about the level and scope of due diligence they have performed on the underlying assets.

due diligence and/or verify the information, we also recommend that the following footnote be included in Provision 1.7:

> *The Technical Committee does not intend that Provision 1.7 would establish a standard for the CRA industry whereby CRAs would be expected to independently verify, audit the accuracy of or conduct "due diligence" with respect to the information provided to them.*

Consistent with the preceding paragraph and the proposed footnote, we also refer you to our comments in Annex I about proposed Provision 3.5c.

II. Proposed Provision 2.8c Is Unworkable and May Fail to Resolve the Problem of Rating Shopping

Proposed Provision 2.8c states:

> *A CRA should disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structured and asked it for a preliminary rating of the proposed structured, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating of that same product; or (2) contracts with the CRA for a final rating and does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.*

While the Consultation Report does not clearly specify the rationale for proposed Provision 2.8c, we understand that this provision is intended to discourage underwriters and issuers of structured finance products from attempting to pressure CRAs into providing favorable ratings through the practice of "rating shopping," and/or more transparency with respect to this practice. We appreciate that IOSCO has concerns about rating shopping. We believe, however, that Provision 2.8c is an inappropriate solution to the problem because it: (1) is unworkable; and (2) may fail to resolve concerns about the practice.

1. Provision 2.8c is unworkable because knowledge of the facts giving rise to a CRA's disclosure obligation would lie outside its control

If Provision 2.8c were adopted, CRAs would become responsible for disclosing information about actions taken by originators, underwriters and sponsors of structured finance products after the relationship between the CRA and such parties had ended. Once that relationship had ended, communications between the CRA and the parties mentioned above would cease. The CRA would not necessarily know if the originator, sponsor or underwriter contracted with another CRA for a final rating of the same structure. The same situation could arise if the originator, sponsor or underwriter chose not to publish the CRA's rating but published the rating of another CRA for that same product instead. Even if it tried to monitor the conduct of its former clients, a CRA could not know with certainty that it had identified all the cases requiring disclosure under Provision 2.8c, because it might not have access to all relevant information.

The Participating CRAs believe that it is inappropriate to impose a disclosure obligation on an entity that cannot, as a practical matter, control the means by which it acquires the information that triggers that obligation.

2. Provision 2.8c might not resolve concerns about rating shopping

We believe that requiring CRAs to disclose cases of rating shopping might change the nature of the practice but would not eliminate it. Some originators, underwriters and sponsors of structured securities who wish to avoid being identified by CRAs as rating shoppers likely would get around the disclosure trigger by withdrawing earlier in the process. Others might simply refrain from approaching CRAs that were:

- believed to have more conservative methodologies; or
- less-well established, and whose methodologies were not well-understood or well-tested in the market.

In any case, we believe that Provision 2.8c would not enhance the ability of a CRA to use a more conservative methodology or compete on the basis of the rigor of its analysis.

To address the concerns raised by IOSCO through proposed Provision 2.8c, we believe that the appropriate solution is twofold.

- ***Encourage structured finance issuers to publicly disclose all information reasonably needed to make informed investment decisions***

  Issuers should provide comprehensive disclosure in a standardized manner about: the characteristics of each asset in the asset pool; the structure of the transaction and performance data for each asset in the asset pool; the validation process used to verify the quality of the information provided and all pertinent representations and warranties; and servicer and trustee reports prepared after the issuance of the transaction.

  As it stands today, generally there is limited data in the public market about structured securities prior to their issuance such that neither investors nor CRAs who have not had sufficient contact with the issuer are able to formulate an informed opinion on structured securities. However, if robust information about structured finance products were publicly available once the details of the transaction had been finalized,[6] CRAs could provide higher quality ratings, regardless of whether or not an issuer requested a preliminary rating. As noted by IOSCO in its report, the dissemination of unsolicited ratings, where possible, likely would reduce the frequency of rating shopping, since rating opinions could be disseminated into the market regardless of whether the issuer specifically contracted with the CRA or not. As a result, in many circumstances market participants would have the benefit of multiple and potentially diverse opinions about the same transaction. Finally, and most importantly, having the underlying

[6] Given their complex and mutable nature, structured finance products may not lend themselves to unsolicited ratings before that time.

data published by the issuers or originators would allow investors to form their own opinions about the strengths and weaknesses of a particular transaction, which could support authorities' efforts to discourage the use of ratings for purposes other than an objective measure of relative credit risk.

- ***The disclosure obligation that IOSCO seeks to impose on CRAs should lie with issuers/originators.***

  For the reasons stated above, the Participating CRAs recommend that Provision 2.8c be deleted from the IOSCO Code and instead that global regulatory authorities encourage issuers and originators to provide more and better quality information to the public.

  If IOSCO believes that disclosure about rating shopping is material to the making of an informed investment decision, we suggest that the disclosure obligation should rest with the issuer or originator, since that party would be in the best position to provide information regarding its activities in relation to obtaining a rating.

ANNEX I

In this Annex, we offer some technical drafting suggestions regarding certain of the proposed changes to the IOSCO Code.

Provision 1.7-2

An internal, centralized function responsible for the formal review of rating criteria and methodologies can be an important mechanism in reinforcing the rigor of our analytical methodologies. In particular, such a function can play a key role in developing and vetting rating criteria and methodologies as well as measuring and reporting on rating performance. Transparent and rigorous criteria and methodologies are also an important element in managing the dialogue between analysts and issuers because these criteria and methodologies are the foundation for these discussions.

Consistent with the objective underlying proposed Provision 1.7-2, the Participating CRAs believe that each CRA should conduct formal and periodic, internal reviews of rating criteria and methodologies, and significant changes to such criteria and methodologies, to promote ratings quality.

We also believe, to the extent feasible, given the size and scope of a particular CRA's credit rating services, that this review function should be "independent". We interpret the term "independent" in proposed Provision 1.7-2 to mean independent of the business lines in the CRA that are principally responsible for rating various classes of issuers and obligations. We note that credible CRAs may focus credit rating services either geographically and/or on certain asset classes of issuers and obligors, and consequently, it may be impracticable for some of these CRAs to adopt such an independence standard. We believe, however, that all CRAs should create and implement a rigorous, formal and internal review function. We ask that IOSCO clarify in its final report and final revisions to the IOSCO Code that the term "independent" does not necessarily call for this function to be external to the CRA. We also request confirmation that it is appropriate for a CRA to consider the size and scope of its credit rating services in determining whether it is feasible for it to make this review function independent of the business lines of the CRA that are principally responsible for rating various classes of issuers and obligations.

Accordingly, we suggest the following modifications:

1.7-2 The CRA should establish *and implement a rigorous and formal, internal* ~~*an independent*~~ *review function* *that will be* *responsible for periodically reviewing the methodologies and models and* *significant* *changes to methodologies and models it uses.* *Where feasible and appropriate for the size and scope of its credit rating services, this function should be independent of the business lines that are principally responsible for rating various classes of issuers and obligations.*

Provision 1.7-3

The role of CRAs is to provide opinions about creditworthiness. As noted above, our opinions are not, and should not be deemed to be, statements of fact. We agree that a

CRA should refrain from publishing an opinion if it believes that its opinion is not based on sufficient information or analytical expertise. However, we are concerned that, as drafted, Provision 1.7-3 would inhibit our ability to provide opinions since the concept of raising "serious questions" is subject to broad interpretation. Furthermore, the rationale for discouraging CRAs from providing credit ratings for new types of structured finance products that do not fit within "established categories of credit ratings" is unclear. We are concerned that this Provision would have a detrimental effect on the development of new rating methodologies and adversely affect rating quality by inhibiting innovation. We therefore suggest that the language be modified as follows:

> *1.7-3 ... In cases involving ~~where the~~ complex,~~ity~~ ~~or~~ new types of structures ~~of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credit rating for the security that fits within its established categories of credit ratings~~, the CRA should refrain from ~~issuing~~ providing a credit rating unless it believes that it has sufficient information and analytical expertise to do so.*

Provision 1.14-1

Provision 1.14-1 states that: "*A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.*" We fully agree with the CRA Task Force that it is important to articulate clearly the limited role that CRAs play in the structured finance market. However, it is also important that rating analysts be free to have a dialogue with issuers about the credit implications of proposed securities. As the Task Force may know, in the past CRAs have at times been criticized as being "black boxes" (i.e. not sufficiently open about our methodologies in our conversations with issuers and investors). Over the past several years, and in light of the existing IOSCO Code, we have taken significant strides to improve our analytical transparency. In this regard it is well understood that it can be helpful to the rating process for CRAs to have ongoing dialogue with issuers and their advisers about credit risks.[7] Accordingly, we recommend that the IOSCO Code also describe such activities, thereby providing greater comfort to investors that these discussions are properly conducted to avoid a conflict of interest. We suggest the following language:

> *In assessing the credit risk of a structured finance transaction, the CRA's analysts may properly hold a series of discussions with the issuer or its advisers in order to: (1) understand and incorporate into their analysis the particular facts and features of the structured finance transaction, and any modification, as proposed by the issuer or its agents; and (2) explain to the issuer or its agents the credit rating implications of the CRA's methodologies as applied to the issuer's proposed facts and features.*

[7] If originators and sponsors of structured products are prohibited from having conversations with rating agencies, the rating process could turn into a "guessing game" rather than a relatively straightforward conversation about the application of our analytical methodologies to a particular transaction.

Provision 2.11b

The Participating CRAs support the objective underlying proposed Provision 2.11b. While the manner in which such reviews of compensation policies and practices would be conducted would depend on a CRA's particular size, organizational structure and circumstances, to the extent possible such reviews should be conducted by persons independent of the analytical function. We also believe, however, that the objective of Provision 2.11b can be achieved if such reviews focus on compensation policies and practices for analysts and other CRA employees who participate in the rating process.

Accordingly, we suggest the following modifications:

2.11b The CRA should conduct formal and periodic reviews of compensation policies and practices for analysts and other CRA employees who participate in the rating process to ensure that these policies and practices do not compromise the objectivity of the CRA's rating process.

Provision 2.17

Provision 2.17 calls for "look-back reviews" when analysts leave CRAs. We ask that the Task Force consider modifying this provision so that "look-back reviews" are conducted only when appropriate to address a potential conflict of interest. It would be both inefficient and unnecessary to conduct a look-back review of an analyst's portfolio if, for example, he or she joins a firm with which he or she has had no dealings while employed by the CRA. We suggest the following modification.

2.17 The CRA should establish policies and procedures for reviewing, as appropriate, the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated, or a financial firm, in either case with which the CRA analyst has had significant dealings.

Provision 3.3

Provision 3.3 calls for CRAs to indicate with each of their ratings the methodology that was used in determining the rating. The ratings of the Participating CRAs are made publicly available and are accessible on each of our websites by all market participants. However, many of these ratings, particularly ratings on corporate obligors, are the result of one or more applicable "methodologies" depending on the nature of the entity being rated. In fact, there may be a number of methodologies that may tangentially be incorporated in the analysis of any of one securities issuance. This tends to be less the case in structured finance. Accordingly, we believe that the second sentence in Provision 3.3 should be limited to structured finance and also apply only to the most relevant or the principal methodology.

In addition, we have suggested that the first sentence in Provision 3.3 be amended to reflect the reality that it is the rating announcement, rather than the rating itself (which consists solely of an alphanumeric symbol) in which the Participating CRAs disclose when the rating was last updated. Likewise, it is not practicable for the rating itself (i.e. the alphanumeric symbol) to incorporate a reference to the principal methodology or methodology version that was used. We suggest instead that CRAs should disclose in the structured finance rating *announcement* where the principal methodology or methodology version can be found. Accordingly, we suggest that the proposed new text in Provision 3.3 be amended as follows:

3.3 The CRA should indicate with each of its ratings announcements when the rating was last updated. Each structured finance rating announcement should also indicate where the principal methodology or methodology version that was used in determining the rating can be found.

Provision 3.5b

Provision 3.5b asks that CRAs disclose whether they use a separate set of symbols when rating structured finance products and the reasons for doing so or not doing so. Presently, the industry is weighing the benefits and the potential, negative market consequences if CRAs were to use different symbols or different scales when rating structured securities. Nevertheless, we agree with IOSCO that it is of paramount importance that the users of our products understand the meaning and the application of the various symbols used. We suggest the following minor language modification to make this point more strongly:

3.5b The CRA should disclose whether it uses a separate set of symbols when rating structured finance products, and its reasons for doing so or not doing so. In any case, a CRA should clearly define the use and application of a given rating symbol ~~and apply it in the consistent manner~~ for all types of securities to which that symbol is assigned.

Provision 3.5c

As discussed in more detail earlier, verification of information is not part of the credit rating function. Accordingly, we recommend that Provision 3.5c be amended as follows:

The CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the ~~limits to which the CRA~~ extent, if any, to which it verifies information provided to it by the issuer or originator of a rated security.

ANNEX II

The Participating CRAs are committed to implementing on a timely basis the following measures to enhance the independence, transparency and quality of the credit rating process and help restore confidence in the CRA industry. It should be noted that a number of the measures outlined below have already been implemented or are in the process of being implemented by some or all of the Participating CRAs.

Independence of the Credit Rating Process

1. Each Participating CRA commits to plainly indicate that it does not and will not provide consulting or advisory services to the issuers the Participating CRA rates.
2. The Participating CRAs believe that enhanced disclosure around what we consider to be ancillary and core rating services could assist the market in better understanding the services and products we offer. Accordingly, each Participating CRA will define and publish what it considers, and does not consider, to be an ancillary business and why.
3. The Participating CRAs' analysts do not make proposals or recommendations regarding the creation or design of securitization products. To make this clear to the public, each Participating CRA commits to incorporate into its code of conduct a prohibition on this activity.
4. Each Participating CRA has adopted, or will adopt, policies and procedures for reviewing, as appropriate, the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated, or a financial firm, in either case with which the CRA analyst has had significant dealings.
5. Each Participating CRA conducts, or will conduct, formal and periodic, internal reviews of compensation policies and practices for analysts and other CRA employees who participate in rating committees to ensure that these policies do not compromise the CRA's rating process.
6. The Participating CRAs believe that greater transparency regarding CRAs' fee structures and practices for structured finance ratings could enhance market participants' confidence in the independence of the credit rating process. Accordingly, each Participating CRA commits to disclose a general description of its practices regarding fees charged to structured finance issuers.

Quality of Credit Ratings

7. Each Participating CRA has established, or will establish, a review function made up of senior managers with appropriate experience to review new methodologies and consider the feasibility of providing a credit rating for a new product.
8. Each Participating CRA has implemented, or will implement, a rigorous and formal, internal review function responsible for periodically reviewing the methodologies and models and significant changes to methodologies and models. Where feasible and appropriate for the size and scope of its credit rating services, this function is, or will be, independent of the business lines that are principally responsible for rating various classes of issuers and obligations. These reviews will involve the objective

assessment of criteria and methodologies based on historical credit rating experience, when available.

9. Each Participating CRA assesses, or will assess, whether existing methodologies and models for determining credit ratings of structured finance products are appropriate when the risk characteristics of the assets underlying a structured finance product change materially.
10. Each Participating CRA has established, or will establish, separate teams for assigning initial credit ratings and for conducting ongoing surveillance of structured finance transactions, whenever feasible, with each team having the requisite level of expertise and resources to perform their respective functions in a timely manner.
11. Each Participating CRA commits to ensuring that adequate personnel and financial resources are allocated to monitoring and updating its ratings. Each Participating CRA commits to evaluating its internal processes and market trends regularly so that it maintains the operational flexibility to enable it to dedicate the resources needed to monitor existing ratings and conduct reviews on a timely basis.
12. Each Participating CRA already has professional development and training programs designed to enhance the quality of our rating analysis and CRA analysts' understanding of relevant policies and procedures. Each Participating CRA will include in its code of conduct a commitment to adopt and maintain a continuing education program appropriate to the nature of its business. Each Participating CRA has assigned, or will, assign responsibility for the oversight of the program's implementation and effectiveness to an appropriate person or group within the CRA.
13. Each Participating CRA commits to working with market participants on measures that could enhance the quality and transparency of information regarding assets underlying structured finance securities available to the investing public.
14. Each Participating CRA has adopted, or commits to adopt reasonable measures regarding the information it uses in assigning a rating to the end that such information is sufficient to support a credible rating.

Transparency

15. Each Participating CRA commits to clearly indicating the attributes and limitations of credit rating opinions. To raise market awareness about what credit ratings do and do not measure, the Participating CRAs have developed and commit to disclosing in a prominent manner, a statement along the following lines:

> Credit ratings are opinions regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk or price volatility. Credit ratings are not a recommendation to buy, sell or hold any securities. In connection with their rating analysis, CRAs rely on the information provided to them that is believed to be accurate and reliable but do not undertake any independent verification of the accuracy of that information.

16. The Participating CRAs commit to playing an active role in raising awareness among investors and other market participants about the meaning of credit rating opinions, the credit rating process and the role of CRAs in financial markets.
17. Each Participating CRA that rates structured finance products has been working independently to develop options, such as new analytic tools or supplementary disclosures, for consideration by market participants and is committed to working with users of its credit ratings to: (1) determine which tools and information they would find most useful in their analysis of the credit risk of structured finance products; and (2) analyze how best to provide that information. Among other things, each Participating CRA is providing, or will provide, more disclosure about key model and methodology assumptions and the sensitivity of the rating to changes in these assumptions. Each Participating CRA has expanded or commits to expanding the initial and ongoing information it provides on the risk characteristics of structured products.
18. Each Participating CRA commits to disclosing whether its uses a separate set of symbols for rating structured finance products and its reasons for doing so or not doing so. In either case, each Participating CRA commits to clearly define the use and application of a given rating symbol for all types of securities to which that symbol is assigned.
19. Each Participating CRA already indicates with each of its rating announcements when the rating was last updated. Each Participating CRA that rates structured finance products commits to indicate with each structured finance rating announcement where the principal methodology or methodology version that was used in determining the rating can be found.
20. The Participating CRAs will create a centralized, industry portal to house our ratings performance studies and other relevant data.
21. The Participating CRAs will make available ratings performance data to regulatory authorities, upon request, to allow those authorities to conduct their own studies of ratings performance.
22. Each Participating CRA is in the process of reviewing the clarity and ease of access to critical information on our websites regarding the fundamental elements of our credit rating process and our analytical methodologies. Following this review, each Participating CRA will implement any technological improvements that it considers appropriate to meet this commitment. Among other things, each Participating CRA will publish in a prominent position on its home webpage links to: (1) its code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.

Joint Industry Response

23. The Participating CRAs recognize the value in discussing the issues facing our industry and responding to regulators as a group whenever appropriate. We are committed to considering actively and carefully the continuation of our work together, as appropriate, to discuss industry practices and facilitate dialogue with authorities and market participants.

European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

IOSCO
Attn.: Ms. Kim Allen
k.allen@iosco.org

23 April 2008

EAPB comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

The EAPB would like to thank IOSCO for the possibility to submit our comments on the role of credit rating agencies in structured finance and on the recommendations for modifying the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO CRA code of conduct"). We would very much appreciate CEBS taking these comments into account.

A. General Comments

The EAPB very much appreciates IOSCO's proposal to amend the IOSCO CRA code of conduct and agrees, in general, with IOSCO's considerations set out in the consultation paper.

Market players, but also legislators, supervisory authorities and central banks rely to a great extent on external ratings by CRAs. Therefore, **high demands should be made on CRAs with regard to the quality and accuracy of their ratings as well as to the CRA's independency and the transparency of their processes and methodologies**.

Basically, we think that the current principle of non-binding rules by way of a code of conduct should not be changed, even given the oligopolistic structures and the CRA's role in the current market turmoil. The CRA code of conduct is best suited to provide the flexibility needed in the field of ratings. Given the non-binding nature of the code, however, it is all the more important to make sure that the **IOSCO CRA code of conduct is accurately and consistently implemented** by the CRAs. The current "comply or explain" approach should therefore be enhanced. Furthermore, we strongly suggest to introduce a periodic external **monitoring process** which should cover in particular also rating methods and models as well as the internal governance of the CRAs.

In the following, we would like to make some more specific comments on IOSCO's considerations.

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B. Specific comments

- **Definitions**

Some of IOSCO's modifications to the IOSCO CRA code of conduct are specifically geared to structured products. However the term "structured finance products" is used very differently in many cases. Therefore, we strongly suggest to precisely define the term "structured finance products" at the outset of the IOSCO CRA code of conduct.

In this context, we would like to underline that "*Pfandbriefe*" and other covered bonds do not fall within the scope of structured products. *Pfandbriefe* are collateralised bank bonds where the bank is the issuer. The collateral remains on the bank's balance sheet and there is no tranching. Therefore, *Pfandbriefe* and other covered bonds are completely different from a typical structured financial product, as outlined in IOSCO's consultation paper.

From our point of view, the Committee of European Securities Regulators (CESR) provides a helpful determination of structured finance products in its consultation paper titled "The role of credit rating agencies in structured finance:

> *"Two main characteristics of structured finance products are the pooling of assets and the tranching process which is designed to create seniority ordering among the different tranches of securities. Senior classes of securities are designed in order to be immune, to a certain extent, from default losses, which are initially borne by riskier (equity and mezzanine) tranches. This segmentation enables the product to appeal to investors with different risk profiles." (para 36).*

- **CRA procedures and policies**

Given the oligopolistic nature of the credit rating market, we strongly believe that wide-ranging transparency with regard to fee structures is absolutely necessary. Fee information and fee structures should be comprehensible. Therefore, we suggest, that CRAs should disclose the entire fee structure including the changes thereto over time (para 2.8.).

- **Transparency**

In the EAPB's point of view, the disclosure requirements for CRAs proposed by IOSCO are insufficient.

From our point of view, information on the stability of ratings is of particular importance. Therefore, CRAs should be engaged to provide concrete information on

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- o the assignment of probabilities of default to ratings;
- o the assumed correlation of the underlying structured portfolios;
- o the stress-tests applied; as well as
- o the consequences of different scenarios for the rating.

We therefore suggest to specify the wording under Para 3.5. and 3.5.c as follows:

> "The CRA should publish sufficient information about its procedures, methodologies and assumptions (…) *as well as the sensitivity of the outcomes to small changes in the assumptions (for example on correlation and on stress tests). The information provided should enable market participants to understand the genesis of a rating*." (3.5.)
>
> "The CRA should ~~assist~~ *supply* investors ~~in developing a greater understanding of~~ *with all information necessary to understand* what a credit rating is, …". (3.5.c.)

Furthermore, we would in particular welcome **periodic reports on rating results and changes of all CRAs**. In our point of view, it would be eminently important to know the defaults per rating class. These reports should be standardised and ideally made publicly available. At least, these reports should be submitted to regulatory authorities. In this regard, we do not share the CRA's concerns that standardised reporting would lead to a unification of rating methodologies.

Please do not hesitate to contact us if you have any questions.

Kind regards,

Henning Schoppmann	Walburga Hemetsberger
EAPB	EAPB

The European Association of Public Banks (EAPB) represents the interests of 29 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.

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European Fund and Asset Management Association

08-254 25 April 2008

To: **IOSCO General Secretariat – Ms Kim Allen**

From: **Peter De Proft & Larissa Fiedler**

Subject: **Comments by EFAMA on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies**

Dear Ms Allen,

The European Fund and Asset Management Association (EFAMA)[1] welcomes the opportunity to comment on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies.

EFAMA's members are important investors in bonds and therefore review ratings by credit rating agencies as part of their investment process. Moreover, integration of ratings into other regulatory regimes (i.e. European Capital Requirements Directive) gives them more weight. Therefore, EFAMA has a keen interest in a well-functioning market of credit rating agencies.

EFAMA globally agrees with the analysis of the current role of credit rating agencies in structured finance markets and welcomes the recommendations to modify the IOSCO Code of Conduct. In particular, EFAMA supports IOSCO's request that:

- CRAs should make clear the limitations of their ratings;
- CRAs should ensure that adequate personnel and financial resources are allocated to monitoring and updating their ratings;
- CRAs should define what they consider to be an ancillary business and why;
- Each rating should indicate the principal methodology or methodology version that was used in determining the rating.

Nevertheless, EFAMA would like to comment on the following modifications to the Code:

Quality and integrity of the rating process

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[1] **The European Fund and Asset Management Association (EFAMA)** is the representative association for the European investment management industry. Through its member associations from 20 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, as well as its corporate members, EFAMA at year-end 2007 represents over €16.5 trillion in assets under management, of which €7.9 trillion through over 46,000 investment funds.

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Paragraph B.1.9 letter c:

Some EFAMA members question the timing of some of the recent mass rating changes.
Sometimes CRAs seem to be late or at least reluctant to change ratings. For instance, structured finance deals in line with performing assets and significant improved credit enhancement usually do not seem to receive an upgrade on time. Therefore, CRAs should improve the rate of deal specific rating actions versus mass rating changes.

CRA Independence and avoidance of conflicts of interest

Paragraph B.2.8 letter b:

Some EFAMA members would like to see disclosure whether a CRA receives 5 % or more of its annual revenue from a single issuer, originator, arranger, client or subscriber, and not 10 % as suggested by IOSCO.

One EFAMA member suggests that a change to the compensation system of CRAs should be examined with the aim of switching from an upfront to an ongoing payment, depending on performance and volatility of the ratings.

Paragraph B.2.8 letter c:

EFAMA members believe that the policy proposed to discourage "ratings shopping" represents an interesting approach which might help to increase confidence in the integrity of ratings.

Some EFAMA members see a need to discourage "rating shopping" even further: CRAs should be required to make provisions in their rating contracts that the ratings on all tranches of a structured finance deal have to be disclosed to prevent issuers/arranging banks from suppressing the publication of ratings they do not deem necessary. This would enable investors to make an informed decision in light of all ratings on a specific deal.

CRA Responsibilities to the investing public and issuers

Paragraph A.3.3:

EFAMA members agree with the request that each rating should indicate the principal methodology or methodology version that was used in determining the rating.

Some EFAMA members explicitly stress the necessity for publishing key model assumptions, weightings of key parameters and correlations as well as the effect of changes in assumptions and correlations so that investors can assess these underlying assumptions and judge the impact of market disruption on the volatility of ratings. CRAs should make available the base case expectations and assumptions, i.e. the distribution (mean, sigma) over time of expected defaults in the asset pool. Stress cases should be added as well as a comparison of the base case of the deal to the behavior of the structured finance subsector in the region.

One EFAMA member suggests that all this information should be included in the pre-sale report to allow investors to make an informed decision.

Paragraph A.3.5 letter a:

In addition to information on CRA's loss and cash-flow analysis, some EFAMA members believe that it is necessary that investors not only have access to the regular CRA investor reports, but especially to the "issuer reports" or "trustee reports" (which the CRAs receive) since they bear the financial risk. Free access for investors to monitoring data should equally be provided.

Moreover, some EFAMA members would like to see the principle established whereby a structured finance rating can only be assigned to a specific deal if a standard set of minimum disclosure criteria is provided for by the CRA in the investor reports.

Paragraph A.3.5 letter b:

EFAMA members agree that a separate system of symbols for ratings of structured products as opposed to corporate bonds should be seriously considered. Although some members fear that the use of different symbols might confuse less sophisticated investors who might think that the rating process for each type of product might be addressing different issues, not just default risk and loss characteristics, all members share the view that ratings on structured credit are inherently less stable than on corporate bonds.

Whereas some members urge that the decision on a separate system of symbols be carefully market tested, other members argue that such a decision should not be left to the CRA, but should be requested as a principle. In their opinion, the methodology should differ between standard credit ratings and ratings of structured finance products. Default rates, for instance, appear to be different for different types of securities, but resulted in the same rating. Moreover, some credit rating agencies base their ratings for structured products exclusively on probability of default whereas other credit rating agencies incorporate in their ratings an analysis of recovery in the event of loss. Consequently, the use of different methodologies should entail the use of different rating symbols.

Some EFAMA members argue that volatility and liquidity also should be part of the methodology for structured finance products ratings. In addition, IOSCO should not only ask CRAs to apply a given rating symbol in a "consistent manner", but in the "same manner".

Paragraph A.3.8:

One EFAMA member believes that disclosure of the performance of a CRA's ratings should be extended to the disclosure of the volatility of ratings and should differentiate between asset classes as well.

Should you have any queries regarding EFAMA's submission, please do not hesitate to contact me.

Yours sincerely,

Peter De Proft
Director General

EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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25 April 2008

Via E-mail
Ms. Kim Allen: k.allen@iosco.org
IOSCO General Secretariat

Consultation Report on the role of credit rating agencies in structured finance markets

Comments by EFFAS European Federation of Financial Analysts Societies

Dear Ms. Allen,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national financial analyst societies. It has 25 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset Management as well as Investment Advice. We are pleased to comment on the role of credit rating agencies (CRAs) in structured finance markets as well on the proposed modifications of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies as presented in the consultation report as of March 26, 2008. In general, we support the position of the IOSCO suggested by the Technical Committee.

Before we comment on the consultation, we would like to refer to a statement made by the Committee of European Securities Regulators (CESR), given in the Background section of CESR's recent consultation paper (Ref: CESR/08-036) under point # 57, that "the rating process for structured finance also held similarities to corporate finance". We also would like to mention a statement given in the BIS report and cited by CESR, namely that "a number of investors claim to rely almost exclusively on the rating agencies ....".

Based on those two observations, with which we agree, we draw the conclusion that it may be justified not only to revise the IOSCO Code of Conduct, but also to consider revising the exemption of CRAs from regulation. Over the last few years, regulation has been imposed on firms carrying out corporate finance business, financial research, or investment advice, with the goal of ensuring a proper functioning of financial markets. Given the recent developments with the ratings of structured finance products, which gave reason for IOSCO's consultation on the revision of the Code of Conduct for CRAs, we believe that it would be appropriate to reconsider the exemption of CRAs from regulation and make certain provisions of this Code enforceable by law.

We agree with CESR and most market participants that over-regulation should be avoided. We would propose, however, to differentiate between the regulation of a product or a methodology of analysis on the one hand, and the regulation of the governance of market participants, or a rating agency, or a product sale on the other hand. While the former clearly bears the risk of over-regulation and should thus be avoided, the latter may be better suited to ensure the efficient functioning of markets in cases where self-regulation does not fully work.

As ratings are assumed to be designed purely to represent the likelihood of default of the financial instrument to which they apply, CRAs are explicitly exempted from the EU Directive 2003/6/EC respectively the Implementing Directive 2003/125/EC. It is stated in recital 10 that "Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument as of a given date". As such, these opinions do not constitute a recommendation within the meaning of this Directive. However, credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they appropriately disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate."

We believe that this self regulation as described did not work properly in the case of ratings of structured finance products. In addition to the amendments to the IOSCO Code of Conduct as presented, we therefore propose that CRAs should come under direct regulation with respect to conflicts of interest, and also to disclosing methodologies applied.

Proposed modifications of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies

We support the idea of modifying the IOSCO Code and welcome the proposed changes in principle and in particular with regard to the avoidance, management and disclosure of conflicts of interests. To explain our point of view, we will provide comments and remarks on selected subjects.

ad 1. Quality and Integrity of the Rating Process

We agree with all the changes as proposed.

Here we believe, however, that detailed requirements as described in this Code, should not necessarily be transformed into formal regulation.

ad 2. CRA Independence and Avoidance of Conflicts of Interest

We agree with the proposed modifications.

We propose that, in the case of rating structured finance products, the exemption of CRAs from the Directive 2003/6/EC respectively the Implementing Directive 2003/125/EC should not be applied, and that recital 7 should come into force here as well: “Own interests or conflicts of interest of persons recommending or suggesting investment strategy may influence the opinion that they express in investment recommendations. In order to ensure that the objectivity and reliability of the information can be evaluated, appropriate disclosure should be made of significant financial interests in any financial instrument which is the subject of the information recommending investment strategies, or of any conflicts of interest or control relationship with respect to the issuer to whom the information relates, directly or indirectly“.

As defined in article 5 and article 6 of the Implementing Directive 2003/125/EC, all relationships and circumstances that may reasonably be expected to impair the objectivity of the ratings must be disclosed. The disclosure has to be carried out in particular when significant conflict of interest linked to the financial instrument or to the issuers exist. Therefore, information on financial interests has to be disclosed clearly.

Hence, we support that IOSCO Code provisions 2.4, 2.6, 2.7, 2.9 and 2.10 should become a part of respective legal frameworks. This can be achieved in the EU jurisdiction by amendments to the Implementing Directive 2003/125/EC, or by a new Directive, and by corresponding legislation in other relevant jurisdictions.

ad 3. CRA Responsibilities to the Investing Public and Issuers

As stated in article 3 and article 4 of the Implementing Directive 2003/125/EC, it is, amongst other things, required to properly label the output of financial research, to adequately explain the meaning of recommendations, give appropriate risks warnings and scenario analyses.

We propose that equivalent basic regulation shall also come into force for Ratings and Rating Processes. This would be accomplished by making IOSCO Code provisions 3.2, 3.5, 3.6 and 3.10 part of a respective legal framework, or a respective revision of the Implementing Directive 2003/125/EC.

ad 4. Disclosure of the Code of Conduct and Communication with Market Participants

We also support the IOSCO recommendation to publish the CRA’s respective code of conduct, a description of the methodologies used and information about the CRA’s historic performance. We consider this as an important element of transparency.

Yours sincerely,

Fritz H. Rau
Chairman of EFFAS

Giampaolo Trasi
Chairman of the EFFAS MSC

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Tel. 610-642-2411 Segan@Egan-Jones.com

Providing timely, accurate credit ratings to Institutional Investors

April 24, 2008

Ms. Kim Allen
IOSCO General Secretariat
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28006 Madrid
Spain

Re: Comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

We applaud your efforts to modify guidelines for the conduct of credit rating agencies in structured finance markets. However, the market disruption is likely to be extended and repeated until some tangible reforms are introduced. The current condition of a mismatch between the interests of investors and interests of the ratings firm is simply untenable. Until regulators summon the courage to address this fundamental problem, efforts to reform the industry will be viewed in the words of the New York State's Attorney General Andrew Cuomo as simply "window dressing".

Given the fact that issuers naturally seek out the highest possible rating (and thereby reduce their funding costs) and rating firms have a freedom of speech defense from faulty ratings, reforming the industry will require a deft touch. A good starting point is an alignment of rating firm and investor interests. While arguments have been made that regulators should not be involved in deigning business models, after hundreds of billions were lost as a result of flawed ratings, there is little reason for abetting this broken approach. Particularly disturbing was the April 11 Wall St. Journal article, whereby a top Moody's executive insisted that analysts maintain Moody's market share or be fired; the natural outcome is that the rating analysts will adjust standards so they do not lose rating mandates. Our view is that Moody's, S&P, Fitch, and other rating firms should have the right to issue any rating they please, but that if they wish to maintain the imprimatur of government support, they need to wean themselves from issuer compensation.

We find it deeply disturbing that IOSCO has had presumably extensive conversations with issuer-supported rating firms which have failed miserably in assigning timely, accurate ratings and yet has had no discussions with the leading investor-supported NRSRO rating firm which has succeeded in proving timely, accurate ratings.

To begin to reform the industry, we believe some industry misconceptions need to be addressed:

Viability of investor-supported model - the issuer-supported rating firms used a subscription based model from the early 1900's to the early 1970's which was a substantially longer period than the issuer-supported period. Given the large number of new business calls Egan-Jones is receiving, there is growing demand for a business

model where the rating agencies and investors have an alignment of interests. (Egan-Jones has been in business for 16 years.)
Problems are limited to the Structured Finance area - the recent credit failures/breakdowns of New Century, Countrywide, the monolines, Delphi, the home builders, and Bear Stearns were outside of structured finance; the key issue is that inflated ratings facilitated the unsustainable growth and resulting collapse of credit quality. See also Enron and WorldCom as failures of corporate debt obligations.
Issuer-supported Rating Firms distribute their ratings for free to the market - fund managers such as Fidelity pay over $500,000 per year to obtain electronic feeds and additional commentary on their ratings.
The SEC can issue ratings - on March 11th the chairman of the SEC assured the market that Bear had "a good deal of comfort on Bear's capital" and yet Bear effectively failed four days later. The SEC's core role appears to be calming the markets rather than issuing timely, accurate ratings.
Higher "Chinese Walls" will do the trick - where there is a will, there is a way. The April 11th WSJ article regarding Moody's Clarkson firing rating officers for failing to maintain market share is an indication of the core conflicts. The current situation of an incentive for issuing high ratings and no penalty for inflated ratings (because of the freedom of speech defense) is likely to result in serial failures.
More rating firms will "open" the market - the growth of Fitch as a viable competitor to S&P and Moody's has not resulted in more timely, accurate ratings. Arthur Levitt's concern about rating inflation appears to be well-placed.
"They lied to us" - some of the issuer-supported rating firms contend that their failure to issue timely, accurate rating was the result of false information provided by issuers. The issuers have an incentive to skew their information and if the rating firms have no recourse for ascertaining the truth, they will not.
Separate consulting from rating - from a practical standpoint, it is impossible to separate the two; the consulting business is not really a significant and separate business for the major rating agencies. Furthermore, it is extremely difficult to ascertain when a rating firm is simply responding to investment banker questions or structuring securities.
Investor-supported rating firms have conflicts – investor-supported rating firms normally do not know whether investors are long or short and are normally motivated by issuing timely, accurate ratings.
"Investors are at fault" - there is a natural limit on the amount of due diligence most investors can easily perform; a chief investment officer of a non-domestic insurance firm is unable to get the depth of information some of the rating are able to obtain. There is a natural need for reliance on credible agents. A person going to a doctor should be able to assume that the doctor will do his or her best to properly treat that person. Likewise, investors should be able to assume that a rating firm will use reasonable effort to issue timely, accurate credit ratings.

The core issue is the alignment of investor and rating firm interest.

Below are some proposals for addressing the problems. Probably the most important item is the requirement that investors review their usage and selection of ratings.

RATING AGENCY REFORM PROPOSALS

Congress passed legislation in 2006 reforming the "process" by which the SEC certifies companies as Nationally Recognized Statistical Rating Organizations (NRSROs). The specific goal of that legislation was to improve competition by easing entry barriers and the early results are encouraging as additional companies are being certified as NRSROs. However, these are relatively small companies as compared to Moody's, S&P and Fitch, and the scope of the current credit debacle, where even high-quality loans are being rejected by the secondary market, has produced a consensus that "process" reforms are inadequate to address the consistent failings of the major credit rating agencies to fulfill their mission of issuing timely and accurate debt ratings.

It is also a mistake to characterize the shortcomings of the major rating agencies as a structured finance phenomenon and thus to suggest, as have many, that the problem can be addressed by modifying procedures solely as they relate to valuing asset-based securities. Doing so would be to ignore the corporate credit ratings involved in Enron, WorldCom and numerous other instances during the last decade when company debt was being rated as investment grade just prior to their bankruptcy filings. It would likewise ignore the current situation confronting the so-called "monoline" insurers such as MBIA, ACA, and FGIC, which carried high investment grade ratings up through and even during the time period when state insurance officials have been actively arranging multi-billion restructurings of these companies.

1. DISCLOSURE BY RATING AGENCY

The publication of any debt rating, whether in written reports or on websites, should be accompanied by a prominent disclosure statement indicating how the entity which provided the rating has been compensated. For example, if a rating agency is paid by the issuer of the securities, a securities dealer, a securities broker or any other party being compensated from the proceeds of the sale of the debt obligations being rated, this fact would be disclosed. If the rating agency's report is paid for by investors or any other party, it would likewise be required to disclose the generic source of its compensation.

2. DISCLOSURE BY INSTITUTIONAL MONEY MANAGERS

Fiduciaries such as mutual funds, pension funds and investment advisors currently disclose the general risk profile of a particular fund in their annual or more frequent investor reports. If the fiduciaries invest in rated debt instruments, they should also be required to disclose and describe the extent to which they rely on external ratings and whether or not those ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

3. ELIMINATION OF SEC EXEMPTION

Rating agencies are exempt from the SEC's Fair Disclosure rules (Regulation FD), which can allow them special access to material nonpublic information from issuers of corporate debt. This is a form of information monopoly which puts the investing public at a disadvantage and contributes to the perception that rating agencies "know better." This special treatment should be ended in order to ensure the uniform release of credit information to all market participants.

If Regulation FD is not abolished, then, at a minimum, issuers soliciting ratings for a corporate or asset-based security should be required to provide their offering data and related information to all SEC designated NRSROs which can then decide whether or not to rate the issue. This can be easily accomplished through a secure, NRSRO-access only web site, as is utilized today by all the major investment banking firms for M&A transactions. Once offered, this information cannot be withdrawn from an individual rating agency, as was recently done recently by MBIA when the company became concerned that Fitch was likely to downgrade its status.

4. BUSINESS MODEL INDEPENDENCE

Both Moody's and S&P followed the "investor paid" business model from their founding in the early 1900s until the 1970s when the shift to the "issuer pay" business model came into prominence. As part of its recent exposé of the industry, *Barron's* suggested that rating agencies "be encouraged to make their money from investor subscriptions rather than fees from issuers, to ensure more impartial ratings." One way to do this would be to phase in a requirement that any rating agency, in order to maintain its NRSRO designation, derive a given percentage of its annual revenues from investors rather than relying almost exclusively on issuers.

5. FINANCIAL REGULATORY REQUIREMENTS

Bank capital requirements, particularly after the recent adoption of the so-called Basel II revisions, rely on NRSRO ratings for purposes of prescribing appropriate capital levels. Assets with high quality ratings are subject to lower capital requirements than lesser rated and non-investment grade bonds. Financial regulatory bodies in the US and abroad are increasingly concerned about the impact which inflated ratings may have on the banking system. Since most bond issues carry ratings from two agencies, an antidote would be to require that one of these ratings be from a company which was not compensated by the issuer of the bonds.

As noted in Number 2 above, banks using external ratings to compute their capital compliance should also be required to disclose in their SEC and other regulatory filings the extent to which they rely on NRSRO ratings to value their bond portfolios and the rationale for this reliance, including whether or not those external ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

Below is a copy of our letter to the SEC concerning the effective failure of Bear Stearns . The letter provides guidance regarding the problems of the current regulatory system.

March 23, 2008

Chairman Christopher Cox
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Mr. Cox

Re: Dysfunctional Regulatory System

The near failure and extraordinary rescue of Bear Stearns underscores holes in the regulatory system. Your letter dated March 20, 2008 to Dr. Nout Wellink of the Basel Committee on Banking Supervision, states Bear Stearns had sufficient capital but that Bear's liquidity rapidly evaporated because of a failure of confidence. Our view is that Bear's capital was over-stated because of inflated ratings from issuer-supported rating firms on structured finance investments and inflated ratings on monoline insurers which supported some of Bear's positions. Issuer-supported rating firms have been and continue to be reluctant to cause distress for large, important issuers and therefore acted in the normal manner, which was to take action after Bear's problems were widely known. The issuer-supported rating firms maintained an "A" and "A2", stable rating as of the morning of March 14th, less than 48 hours before the bailout commenced. In contrast, Egan-Jones maintained a "BBB-", negative watch rating.

To address the regulatory problems, we are recommending a series of reforms with the main objective to be a recognition of the differences between issuer-supported and investor-supported rating firms. I hope that these reforms will be addressed soon; the conflicts cannot be managed as is often suggested by the issuer-supported rating firms.

I would be happy to discuss our views and ways to prevent future failures

Very truly yours,

Sean J. Egan

cc: Dr. Nout Wellink, Chairman of Basel Committee on Banking Supervision
Michel Prada, Chairman, Technical Committee of the International Organization of Securities Commissions (IOSCO)
Tokio Morita, Chairman, IOSCO Standing Committee Three
Mario Draghi, Chairman, Financial Stability Forum

POSITION PAPER

ESBG response to IOSCO consultation on Credit Rating Agencies

29 April 2008

ESBG

DOC 0404/08

1. GENERAL REMARKS

The European Savings Banks Group (ESBG) welcomes the opportunity to comment on the IOSCO consultation regarding the role of Credit Rating Agencies in structured finance markets. This year's assessment of Credit Rating Agencies' (CRAs) compliance with the IOSCO Code of Conduct is of particular importance due to the current financial market turmoil. CRAs play a crucial role on financial markets, and confidence of market participants in the quality and reliability of ratings is fundamental for the functioning of the market in structured financial products.

The importance of having high quality ratings is reinforced by the role attributed to credit ratings under Basel II. Weaknesses in the rating process have contributed to the loss of confidence in this area, although CRAs cannot be blamed to be solely responsible for this development. Although it is for CRAs themselves to correct those weaknesses, the regulatory framework also needs to be assessed. Therefore we welcome IOSCO's as well as CESR's work on this topic. We would like to refer to our contribution to the recent CESR consultation and in particular highlight our agreement with CESR's definition of structured finance products, described in points 35 and 36 of CESR's consultation paper.

2. COMMENTS ON IOSCO RECOMMENDATIONS

In general terms, we welcome the reflections by IOSCO, presented in its consultation paper. As regards the specific recommendations for amending the IOSCO Code, as proposed in the consultation paper, the ESBG would like to make the following comments:

1. CRA should take steps that are designed to ensure that the decision-making process for reviewing and potentially downgrading a current rating of a structured finance product is conducted in an objective manner. This could include the use of separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, or other suitable means. If separate teams are used, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner. Subsequent monitoring should incorporate subsequent experience obtained. Changes in ratings criteria and assumptions should be applied where appropriate to subsequent ratings.

Comment: This proposal addresses the important issue of adequate procedures and qualified human resources. The ESBG doubts that CRAs have maintained sufficient human resources, in particular for the monitoring of the rating of an already rated product. Therefore we welcome IOSCO's call for requisite resources. We consider that reduced upfront fees and increased monitoring fees could diminish the focus of CRAs on new business/ new ratings. This mechanism would in our view automatically result in a better distribution of the resources. Also, the ESBG would welcome more transparency in terms of CRAs resourcing. In addition, transparency about the internal structure and the decision making process could offer valuable information.

2. CRAs should establish an independent function responsible for periodically reviewing both the methodologies-and-models and the changes to the methodologies-and-models used in the rating process.

Comment: The ESBG welcomes the proposal to create an independent review function as a valuable first step towards a better evaluation of CRA methodologies and models.

As stressed in our response to CESR, ESBG Members are concerned that the models used for structured finance products by CRAs have failed and therefore, we see the necessity for an analysis of the possibility of supervising CRAs' models. With regard to the IOSCO proposal to create an independent function for reviewing changes to the methodologies, we believe that such a step might not be sufficient and that the involvement of an external supervisory body should be considered. The function of the supervisory body would be to examine and authorize the changes.
In this context, ESBG would like to highlight that CRAs should be clear as to whether a change in the methodology used or in the performance of the underlying asset pools has led to a rating review. Information about the frequency of rating reviews and causes for such reviews would also be an added-value.

12. A CRA should define what it considers and does not consider to be an ancillary business and why.

Comment: The ESBG believes that the **precise and clear** definition of an "ancillary business" is of particular importance and we therefore propose that the text should be amended to reflect such definition. We doubt that it should be exclusively up to CRAs to define ancillary business. We recommend that CRAs, other market participants and supervisors should together develop a clear distinction between ancillary and core rating business.
In more general terms, the ESBG considers that the degree of information exchange between CRAs and issuers is compared to traditional instruments much higher in the area of structured finance. The clear separation between the rating and advisory functions is increasingly blurred and this could lead to a rise in potential conflicts of interest. CESR has proposed that IOSCO should provide more clarity in this field and should act as a benchmark of acceptable practice for CRA interaction with issuers of structured finance products. The ESBG would like to reiterate its support for this proposal.

14. In order to discourage ratings shopping, a CRA should disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating; or (2) contracts with the CRA for a final rating and does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.

Comment: The ESBG understands the reasoning behind this proposal. As regards the practical implementation of the disclosure, the ESBG advices to disclose the cases in an aggregated and anonymous manner in order to avoid reputation damages for the issuers.

16. Where a CRA rates a structured finance product, it should provide investors and/ or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.

Comment: The ESBG welcomes this addition. Nevertheless we assess that additional information is necessary. We suggest adding information on the sensitivity of the outcomes to small changes in the assumptions (for example correlation and stress tests), the probability of default and migration risk under point 3.5 of the Code (i.e. above 3.5.a.=change 16).

17. A CRA should disclose whether it uses a separate set of rating symbols for rating structured finance products, and its reasons for doing so or not doing so. In any case, a CRA should clearly define a given rating symbol and apply it in the same manner for all types of products to which that symbol is assigned.

Comment: All ESBG Members agree that more transparency in the field of structured products is necessary and the ESBG therefore welcomes all efforts contributing to enhanced transparency. As regards the concrete question whether or not CRAs should establish a separate set of rating symbols for rating structured finance products, diverging views were expressed within the ESBG. Specifically, some ESBG Members highlight that the current system has the advantage of making it possible to compare different kinds of products in terms of their probability of default. For these Members, strengthening the general disclosure of differences between the rating of structured finance transaction and the rating of traditional instruments, e.g. as regards the risk structure and the stability of the rating, would be sufficient and as such, the current system could be kept. Other ESBG Members would rather opt for the creation of a separate set of rating symbols for structured products. A separate set could more easily show the considerable differences between structured finance transaction and traditional instruments. With such a new structure, it could be easier to include the specific risks of structured products, such as liquidity, price volatility and legal risks, and thereby better situate the structured products in the exposure world.

18. A CRA should disclose the principal methodology or methodology version in use in determining a rating.

Comment: The ESBG considers that it is important that the methodology or methodology version is easily comprehensible. This requires a detailed description and cannot be limited to the "**principal** methodology".

19. A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.

Comment: The ESBG welcomes this proposal aiming at increased transparency and accessibility of information. We propose to extend the scope of point (2) and add an indication about the last update (date and changes made).

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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An Affiliate of SIFMA

Securities Industry and Financial Markets Association

25 April 2008

Ms Kim Allen
IOSCO General Secretariat
Calle Oquendo 12
28006 Madrid
Spain

ESF/SIFMA RESPONSE TO IOSCO TECHNICAL COMMITTEE CONSULTATION REPORT ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS

Dear Ms Allen

The European Securitisation Forum[1] (ESF) and Securities Industry and Financial Markets Association[2] (SIFMA) are pleased to respond to the March 2008 IOSCO Technical Committee Consultation Report (CR) on the role of Credit Rating Agencies (CRA) in Structured Finance Markets (SF).

This response reflects preliminary feedback from ESF and SIFMA members in Europe. Please note that as a global organisation, SIFMA is, through a member task force, entering into a broader study of the role of CRAs. The results of that study could change the emphasis of our initial recommendations, which we are providing now so as to not impede the IOSCO process. We will forward a copy of this broader study reflecting the position of SIFMA members globally to IOSCO when it is completed.

We believe that CRAs play a very important role in the capital markets, particularly in SF where they have been critical to increasing the availability of credit and distribution of risk. Nevertheless the recent market turmoil and perceived weaknesses in ratings have given rise to legitimate concerns relating to, inter alia: the rating process, conflicts of interest and transparency.

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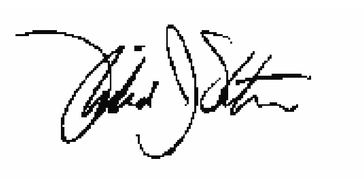
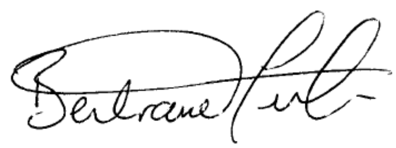
[1] The ESF is the voice of the securitisation and CDO marketplace in Europe, with the purpose of promoting efficient growth and continued development of securitisation throughout Europe. Its membership is comprised of over 150 institutions involved with all aspects of the securitisation and CDO business, including issuers, investors, arrangers, rating agencies, legal and accounting advisors, stock exchanges, trustees, IT service providers and others. The ESF is affiliated with SIFMA. The ESF has two sister organisations: the American Securitization Forum and the Asia Pacific Securitisation Association.

[2] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving an enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in London, New York, Washington DC, and its sister Association, the Asia Securities Industry and Financial Markets Association (ASIFMA), is based in Hong Kong.

Please find attached in Annex 1, our comments on whether the CR correctly analyses the role of CRAs in SF and on the proposed recommendations for modifying the IOSCO Code of Conduct Fundamentals for CRAs (IOSCO Code). Our response is intended to serve as a basis for further discussion with IOSCO and the wider regulatory community and we would welcome the opportunity to do so at your convenience.

Yours sincerely





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ANNEX 1

SIFMA/ESF RESPONSE TO IOSCO TECHNICAL COMMITTEE CONSULTATION REPORT ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS

COMMENTS ON ANALYSIS OF ROLE OF CRAs IN SF

Background to the Task Force Work

Given that CRA related issues are only one of many factors relevant to the market turmoil, we note and support the statement in the CR that the conclusions of the IOSCO CRA Task Force are incorporated in the IOSCO Subprime Task Force. We assume that the CRA Task Force will only finalise its conclusions in light of responses to the CR.

Reliance on CRA Ratings

The text alleges that CRAs do not generally confirm the validity of the underlying data provided to them and that in some cases some CRAs relied on information that prima facia appeared questionable or in the broader context of rapid market changes uncertain or of dubious quality. Irrespective of whether these allegations are true, we would caution IOSCO not to seek a shift in the due diligence obligation from the issuer to the CRAs, which would have significant legal and cost implications for the industry.

We would also suggest more balanced terminology as some of the language used is rather inconsistent: e.g. this section of the CR first talks of SF and particularly CDO investors as appearing to have relied ‘heavily’ or ‘solely’ on ratings. This language is later softened to the effect that ‘in some cases’ credit ratings ‘appear’ to have taken on greater importance than they might in most other debt markets. To remove the resulting uncertainty we would suggest the use of more consistent terms.

COMMENTS ON PROPOSED RECOMMENDATIONS FOR MODIFYING THE IOSCO CODE

As a general comment, we note and support the retention of the comply or explain provision (Rule 4.1) according to which CRAs may in their own code of conduct deviate from the IOSCO Code providing they explain where and why these deviations exist and how any deviations nonetheless achieve the objectives of the IOSCO Code. We believe that the comply or explain provision provides the necessary flexibility for CRAs.

Recommendation 1: A CRA should take steps that are designed to ensure that the decision-making process for reviewing and potentially downgrading a current rating of a structured finance product is conducted in an objective manner. This could include the use of separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, or other suitable means. If separate teams are used, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner. Subsequent monitoring should incorporate subsequent experience obtained. Changes in ratings criteria and assumptions should be applied where appropriate to subsequent ratings.

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We agree that the rating review process must be objective and independent of the initial rating process. Although we also agree that this objectivity can be achieved by using separate analytical teams for determining initial ratings and for subsequent monitoring of SF products we are concerned that such separation may undermine consistency and experience throughout the ratings process and ultimately weaken ratings. Mandating the use of separate teams may also challenge the resources of smaller CRAs. On this basis we therefore welcome that the recommended amendment to the IOSCO Code acknowledges that there may be alternatives to separate teams when seeking to ensure the objectivity of the ratings review process.

Recommendation 2: CRAs should establish an independent function responsible for periodically reviewing both the methodologies-and-models and the changes to the methodologies-and-models used in the rating process.

We support the proposal for CRAs to set up an independent function to review rating methodologies and models and changes thereto. We believe that shortcomings in the assumptions underlying the methodologies and models applied at the time of the initial rating (alongside the rapidly deteriorating performance of underlying assets) to be the major causes of any weaknesses in ratings. To address these shortcomings, we agree that CRAs should internally set up an independent function to regularly review the appropriateness of methodologies and models used in the ratings process.

Recommendation 3: CRAs should adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating. If the rating involves a type of financial product with limited historical data upon which to base a rating, the CRA should make clear, in a prominent place, the limitations of the rating and any risks associated with credit ratings of such products.

We agree that CRAs should make all reasonable efforts to ensure that the information used (including information on the underlying assets and borrowers) will support a credible rating. In this context, we would recommend that the meaning of ‘reasonable measures’ be clarified to help limit uncertainty. As a possible ‘reasonable measure’ it may be worth exploring whether a CRA should request independent verification of the information provided to it. We also agree that if the rating pertains to a type of SF product with limited historical data upon which to base a rating, the CRA should make clear, in a prominent place, the consequent limitations and uncertainties of the rating. More generally, CRAs can and should do more to communicate on an ongoing basis that their SF ratings comprise only an opinion on the probability of default and/or expected loss based on the application of specific models and methodologies to a limited data set. A rating is not a recommendation to buy or sell the rated product and is not and indicator of market, liquidity or volatility risk.

We would however caution IOSCO not to inadvertently cause a shift of the due diligence responsibility onto CRAs. This would create significant costs and legal uncertainties in the industry. We suggest that the IOSCO Code be more aligned to the recommendation of the Financial Stability Forum requiring CRAs to enhance their review of the quality of the data input and the due diligence carried out by issuers while making it clear that CRAs are not responsible for carrying out the due diligence themselves.

Recommendation 4: CRAs should ensure that the CRA employees that make up their rating committees (where used) have appropriate knowledge and experience in developing a rating opinion for the relevant type of credit.

We support the proposed clarification that human resource quality requirements extend to rating committees to the extent that such bodies are used. In this context we note that HR quality requirements will be supported by the ratings review process.

Recommendation 5: CRAs should establish a new products review function made up of one or more senior managers with appropriate experience to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures the CRA currently rates.

Recommendation 5 appears to overlap with recommendation 2 to the extent that both envisage the establishment of a review function to (according to recommendation 2) periodically review methodologies and models and changes thereto, and to (according to recommendation 5) review new methodologies as well as the feasibility of providing ratings for new products. We firstly suggest that IOSCO should clarify that the two functions can be combined so that (particularly smaller) CRAs may manage their resources efficiently. The key is that there is a proper review and escalation process in place with senior level sign-off on material changes to existing methodologies and to the CRA taking on innovative structures.

In addition (and contrary to the statement in the CR analysis section that unsolicited ratings of SF products are very rare) recommendation 5 appears to assume that CRAs have the capacity and inclination to carry out unsolicited examinations of new SF products. We suggest that CRAs will deal with new SF products in same way as corporate products – namely that the issuer will approach the CRA who in turn will initiate the process (which may or may not result in a rating) by assigning a lead analyst, with the appropriate vetting/escalation procedure providing additional protections.

Recommendation 6: CRAs should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credit rating for the security that fits within its established categories of credit ratings, the CRA should refrain from issuing a credit rating.

As stated in our response to recommendation 2, ratings are only assessments of credit risk based on the application of specific methodologies and models to a specific and limited data set. We believe that any weaknesses in ratings have mainly been caused by shortcomings in the assumptions underlying the methodologies and models applied at the time of the initial rating as well rapidly deteriorating performance of underlying assets. On this basis, we therefore support the review of methodologies and models when the risk characteristics of the underlying assets change significantly. As a consequence, CRA will need to carry out ongoing analysis of the underlying assets both in terms of the risks represented by the collateral and the borrowers. In cases where complexity of a SF product or insufficient information about the assets underlying it create uncertainty as to the appropriateness of the CRA's existing rating categories, we support the recommendation 6 for CRAs to desist from issuing a rating.

Recommendation 7: A CRA should prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.

We agree that CRA analysts should not provide creative suggestions regarding the design of SF products and support the proposal as an appropriate tool to address potential conflicts of interest. We believe that the recommendation enjoys wide support and understand that some CRAs already have compliance policies in place which prevent analysts from making proposals or recommendations regarding the design of SF products that the CRA rates.

However, we are concerned that the recommendation may be interpreted as prohibiting the inherently iterative SF process and think the recommendation should be clarified to ensure that analysts retain the ability to discuss transactions with issuers and originators so as to make sure they fully understand the structures they are being asked to rate and can provide feedback on rating scenarios. We do not view this feedback as the CRA 'advising' on the deal but rather providing facts about how the methodologies are being applied and how structural changes will affect targeted ratings based on those methodologies.

Recommendation 8: CRAs should ensure that adequate resources are allocated to monitoring and updating its ratings.

We believe that regular monitoring is important and support the steps taken so far by CRAs to increase resources dedicated to the surveillance of SF transactions. We would encourage CRAs to build on these steps and consider greater flexibility in transferring more resources to surveillance when appropriate. In this context we would encourage CRAs to state and adhere to a minimum frequency of ratings review. Investors have indicated that they want more resources devoted to surveillance and would like expanded surveillance information as to how transactions are performing vs. original expectations.

Recommendation 9: A CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated, or a financial firm with which the CRA has significant dealings.

With a view to addressing potential conflicts of interest, we agree that CRAs should set up detailed policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated, or a financial firm with which the CRA has significant dealings. We would encourage CRAs to explain how those policies and procedures would apply in specific SF scenarios.

Recommendation 10: A CRA should conduct formal and periodic reviews of remuneration policies and practices for CRA employees to ensure that these policies and practices do not compromise the CRA's rating process.

With a view to addressing potential conflicts of interest, we agree that CRAs should conduct formal and periodic reviews of remuneration policies and practices for CRA employees to ensure that these policies and practices do not compromise the integrity and independence of the CRA's rating process.

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Recommendation 11: A CRA should disclose whether any one issuer, originator, arranger, subscriber or other client and its affiliates make up more than 10 percent of the CRA's annual revenue.

Concentrations of revenue sources for any company are material factors for investors, in so far as they may create a perceived risk that that a CRA will be less inclined to use appropriately conservative assumptions in their rating methodologies in order to maintain transaction flow from the client in question. We cannot comment on whether a 10% threshold is the appropriate level for disclosure of concentrations of revenue, but we would encourage the CRAs to develop recommendations for a threshold level at which they disclose material revenue sources. In this context, we would encourage CRAs to consider the implications of interconnected revenue sources that collectively breach threshold levels.

Recommendation 12: A CRA should define what it considers and does not consider to be an ancillary business and why.

We support this recommendation. It is a natural complement to the existing IOSCO Code provision requiring CRAs to separate their credit rating business and analysts from any other business that may present a conflict of interest. In our experience all major CRAs have taken considerable steps to ensure that adequate separation exists between SF credit analysts and ancillary staff and that this separation goes to a more senior management level than used to be the case.

Recommendation 13: A CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the limits to which it verifies information provided to it by the issuer or originator of a rated security.

We agree with this proposal. Although there have recently been improvements in the level of communication with the market on this issue, CRAs can and should do more to communicate on an ongoing basis that their SF ratings comprise only an assessment of the probability of default and/or expected loss (depending on the specific CRA) and are not indicators of stability, liquidity and volatility. We recommend that the CRAs develop a succinct summary to be included on the first page of pre-sale reports as to the basis and limitations of their rating and key numerical and quantitative assumptions utilised in the rating development.

Recommendation 14: In order to discourage ratings shopping, a CRA should disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating; or (2) contracts with the CRA for a final rating and does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.

We agree that a significant issue facing CRAs from a competitive standpoint is the "race-to-the-bottom" whereby CRAs have a natural commercial incentive to develop rating policies which result in the lowest credit enhancement levels so they win the business over a competing CRA with higher credit enhancement levels. This, however, needs to be balanced against the

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reputational risk to CRAs if rating integrity is compromised. Moreover, not all multiple-enquiry scenarios will necessarily constitute 'ratings-shopping'. Many scenarios can occur where preliminary information might be provided to the CRAs who then provide indicative ratings, which then might not be further pursued by the issuer/arranger for reasons unrelated to the precise CRA feedback. Arrangers and other participants should be able to have a constructive dialogue with a CRA as to what possible credit enhancement levels would be, without incurring costly expenses. We also note that successive CRAs may be presented with different iterations of a proposed SF product and that given such changes this cannot be characterized as ratings shopping.

IOSCO's recommendation may help discourage ratings shopping, although we would recommend that CRAs develop their own thresholds for disclosing where a rating request was made but later withdrawn. In this context we caution that the recommendation may also have unintended consequences, for example, the market may move to a situation where the outliers are never approached to rate transactions in a particular sector or where rating fees become much more success based. An alternative tool against ratings-shopping may be for CRAs to regularly publish and explain the development of their own credit enhancement levels in each product over time.

Recommendation 15: A CRA should publish verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.

We support this recommendation.

Recommendation 16: Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.

We support this proposal. Greater disclosure of information such as the base case probability of default or expected losses of the underlying assets of a transaction (and other key figures) when permitted under data protection laws and consistent with CRA confidentiality obligations under the IOSCO Code would provide investors and other market participants more insights on the transactions.

We believe this more detailed analysis and the disclosure of fundamental model criteria is a key to increasing the transparency and understanding of ratings. While much information about ratings models is publically available, there are typically a number of qualitative inputs to models that are not publicly disclosed, yet are tremendously important to the outcome. If a user has access to the underlying information that was used to determine a rating, they are best able to decide whether or not they agree with that rating. It is this separate risk analysis that our members believe would be the most productive avenue to improve transparency. We suggest that at a minimum the following items be covered more extensively in this reporting and analysis: (1) assumptions and methodology used including key quantitative and qualitative criteria; (2) justification of any discrepancy between methodology-implied and actual ratings; and (3) criteria for, and most likely paths to, upgrades or downgrades.

Recommendation 17: A CRA should disclose whether it uses a separate set of rating symbols for rating structured finance products, and its reasons for doing so or not doing

so. In any case, a CRA should clearly define a given rating symbol and apply it in the same manner for all types of products to which that symbol is assigned.

We note that proposal does not mandate the use of a separate set of rating symbols for the rating of SF products. We would not support a new rating scale for SF products, nor do we support a modification of the existing scale or the addition of suffixes. There is some question as to the appropriateness of providing a scoring on other risk factors but we generally believe that trying to finitely score specific risk factors would be confusing to market participants. We also believe that the practical difficulties of implementing such changes to the ratings scale (including e.g. implementing changes to the myriad of references to the current ratings scale in numerous investment guidelines and laws etc) would be significant.

We would instead recommend the separate provision of additional analysis of deal structures and of risk characteristics, as well as the disclosure of the fundamental criteria which underlie the models used to rate securities as the most effective way of improving transparency. In addition we believe that CRA analysts should be prepared to respond to specific questions from market participants as to the rationales for the criteria and assumptions used in the rating models.

Recommendation 18: A CRA should disclose the principal methodology or methodology version in use in determining a rating.

We support this proposal. Whilst methodologies (at least for CDO transactions) are freely available it is sometimes difficult to track which particular methodology has been used to rate a specific issue and whether a rating review has been triggered by a change in that methodology or the performance of the underlying asset pool. To ensure a level playing field across asset classes, we believe that CRAs should highlight clearly to investors which particular methodology a SF rating is based on. CRAs should also be clear as to whether a ratings review has been triggered by a change in methodology or a change in the performance of the underlying asset pools and in both cases the triggering threshold. In this context we would note that methodologies and underlying assumptions/correlations might change as a result of better insights gained from the performance of the underlying asset pools. In the interests of greater transparency, we would also suggest that CRAs disclose their policies on notching.

19. A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses; and (3) information about the CRA's historic performance data.

We support this proposal. While there have been improvements in CRA disclosure we would welcome further enhancements in the accessibility of this information. CRAs can and should make efforts to improve the navigability of their web-sites and make it easier to track changes to methodologies.

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Brussels, 25 April 2008

Re: Comment on the "IOSCO Technical Committee Consultation Report on Credit Rating Agencies"

Dear Sir,

We welcome the opportunity to comment on IOSCO's Consultation Report of March 2008 on "The Role of Credit Rating Agencies in Structured Finance Markets" (hereinafter "the Consultation").

In general we strongly support the proposed changes to the Code of Conduct Fundamentals for Credit Rating Agencies (hereinafter, the "Code of Conduct") in the different areas mentioned in the Consultation. Indeed issuers attach great importance to clear professional ethics for credit rating agencies (hereinafter "CRAs") regarding the transparency of the credit rating process, the quality of information to the market and last but not least, regarding the relation of CRAs with issuing companies.

We support the objective to strengthen processes and procedures at CRAs so that investors and financial markets can be confident that CRAs will produce clear, well-researched and unbiased ratings, which can be easily understood by their users.

In particular we concur with the proposed changes that will help the investing public and/or subscribers to understand the applied methodology and the attributes and limitations of each credit opinion and to clearly distinguish structured finance products from corporate products.

With reference to the proposed changes, we would like to draw your attention to the following:

Proposed change to measure 3.3 - transparency in the applied methodology

We agree that transparency on the applied (version of) methodology is essential to a well informed, properly functioning market.

In order to ensure the integrity and transparency of the rating process for investors, subscribers and issuers alike, it is desirable that they are informed in advance, not only of the methodologies used by CRAs, but also of any changes to these methodologies, especially as the methodologies may differ from one CRA to another.

We believe that the public disclosure on the methodology should include a list of the objective (ratios etc.) and qualitative criteria used by CRAs, whether those criteria are financial or non-financial (quality of management, etc.).

Proposed change to measure 3.5 - informing investors and/or subscribers about structured finance products

The media release accompanying the Consultation indicates that the development of the market for structured finance products has raised serious issues for regulators globally; in certain instances, subscribers have underlined the need for appropriate information on such products and on the basis for the CRA's ratings. This justifies the particular focus on structured finance products where changes are proposed regarding the quality and integrity of the rating process and regarding the responsibilities to the investing public and to issuers.

To further enhance the distinction between structured finance products and other products, we suggest that the Code of Conduct would provide that the CRA's loss and cash flow analysis referred to in measure 3.5 a. should include consideration of the risks attaching to the structured finance products.

In addition, to allow for better understanding of the ratings, we suggest that the Code of Conduct would not leave the choice to use two separate sets of symbols as mentioned in measure 3.5 b.

* * *

We would be pleased to discuss these proposals further and thank you for taking our views in consideration.

Yours faithfully,

Dorien FRANSENS
Secretary General

EuropeanIssuers is a pan European organisation that represents the vast majority of publicly quoted companies in Europe. EuropeanIssuers was formed when EALIC, the European Association of Listed Companies, and UNIQUE, the Union of Issuers Quoted in Europe, combined their organisations in early 2008. Its members are national associations and companies from the following countries: Austria, Belgium, Bulgaria, Cyprus, Finland, France, Germany, Greece, Italy, the Netherlands, Poland, Portugal, Spain, Switzerland and the United Kingdom. These markets count some 9,200 listed companies with a combined market value of some € 8,500 billion. EuropeanIssuers is an International Non Profit Association under Belgian law with registered seat and permanent secretariat in Brussels.

FEDERATION BANCAIRE FRANCAISE

- April 22nd 2008 -

THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS – MODIFICATIONS TO THE IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

The French Banking Federation ("FBF") is the professional body representing over 500 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

As universal banks, the FBF members are highly interested in the evolution of the framework concerning the role of Credit Rating Agencies in structured finance markets, and welcomes the opportunity to comment on the proposed modifications of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies.

As an introduction, the FBF wishes to make a general comment and three statements:

The subprime crisis has contributed to a general crisis of confidence in securitization vehicles. However, confidence in such vehicles is based largely on the financial rating assigned by CRAs at the time of issuance. The rating is in effect a key tool for investors to estimate investment risk.

This is all the more so in the case of ratings for structured finance products or securitization vehicles, by nature more complicated than those of government or corporate bonds.

In recent months, the role of CRAs has been the focus of many questions and criticism.

The FBF considers that in this context, three questions about CRAs should be raised in relation to the current crisis.

- The first concerns **the subject of the rating**. **A clear distinction must be made between rating portfolios or securitization vehicles and conventional corporate or government bonds whose performance depends on the issuer. The scales should not be the same and methodologies should be adapted and disclosed. Naturally, vehicles regulated like credit institutions should be treated as such in the scale of ratings for corporate bonds.**

- The second question concerns the impact of the rating on the expected **liquidity** of the product on the market.

- The third question concerns potential **conflicts of interest** of CRAs, either because they receive remuneration from issuers or because they serve as advisers to arrangers and issue ratings for products.

Hereafter are the main points that the FBF would like to highlight to the attention of the IOSCO Technical Committee.

I. THE RATING OF SECURITIZATION VEHICLES

The securitization market is in large part dependent on the ability of CRAs to issue a financial rating for a transaction and on the confidence that financial players have in their conclusions.

Rating is mandatory under article L 214-44 of the French Monetary and Financial Code "*A document containing an assessment of the characteristics of the units and, if applicable, the debt instruments to be issued by the fund, the receivables that it proposes to acquire [...].and an evaluation of the risks that they represent is drawn up [...]. It is appended to the prospectus and sent to subscribers of units*."

Through their ratings, CRAs provide opinions essential for investors that do not always have the time to review a portfolio (at times consisting of tens of thousands of assets) or the instruments to perform portfolio performance simulations.

They must consequently be able to monitor the evolution of the portfolio of the underlying debt and notify the market in a timely manner in the event of a portfolio downgrade. **That is why the French Banking Federation agrees with the proposal of the IOSCO's consultation report to take into account the monitoring of the object of the notations. IOSCO's Technical Committee even goes further proposing to establish a clear distinction between the function of establishing an initial rating and the one of monitoring (proposed measure 1-9-1of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies).**

For securitization vehicles, the difficulty is based on the fact that the degree of volatility in the rating is not the same as for corporate or government bonds.

In the case of corporate or government bonds, the rating evolves in the event of deterioration in the underlying asset, i.e. the issuer.

However these models have demonstrated their limits and it is noteworthy in respect to the rating of securitization vehicles that CRAs delayed announcing downgrades of RMBS (Residential Mortgage Backed Securities) programs, because of failures in monitoring the underlying assets (the real estate crisis in the US began in late 2006 while announcements of portfolio downgrades date from July 2007).

Rapid changes in methodologies have also highlighted insufficiencies in previous methods used.

Accordingly, increased transparency is necessary about rating methods and changes in methods as well as greater comparability between the methods used by different CRAs. **That is**

why the French Banking Federation agrees with the proposals of the IOSCO's consultation report to:

- disclose on the methodology used to establish the notation;

- establish an independent function responsible for reviewing methodologies and models and changes to the methodologies and models it uses;

- disclose on the Credit Rating Agencies' historic performance.

II. THE LIQUIDITY

The liquidity crisis of the summer that was extended to all securitization vehicles represents a crisis in demand.

The question was raised if CRAs should be responsible for anticipating such developments whereas traditionally their ratings have been based on an analysis of the credit risk of the securitization deal.

It is currently not the mission of CRAs to analyze other market (for example interest-rate risks) or operating risks.

Such a development would significantly modify their role without necessarily improving the legibility of ratings and investor confidence.

The main rating must continue to be based on credit risk and it is important for investors that it represents an opinion on the credit quality of an issue and not on liquidity or price.

If in contrast, CRAs may provide under their responsibility on a case-by-case basis a rating for example on anticipated liquidity, they should do so in a specific and clearly distinct way.

III. CONFLICTS OF INTEREST

The question of potential conflicts of interest within CRAs does not concern their existence which is indisputable and recognized by the CRAs themselves, but rather their management. These conflicts of interest exist either because CRAs receive remuneration from issuers or because they serve as both advisers of arrangers and issue ratings for products.

Consequently, as a first statement, it seems very important that the CRAs involved in the rating of a structured product cannot be also adviser on the same operation and vice versa.

The FBF considers self-regulation to be the simplest and most effective approach to this problem. To this purpose, extension of the IOSCO Code of Conduct published in December 2004 is recommended.

This Code of Conduct applied on a voluntary basis (with the IOSCO exercising only a role of establishing guidelines) was signed by the leading CRAs.

In December 2005 CRAs in Europe adopted the following commitments vis-à-vis the CESR:

- The CRAs will annually send a letter to the CESR outlining compliance with the IOSCO code and explaining any deviation that may exist between their own codes and the IOSCO code;

- CESR will annually organize a meeting with the CRAs to discuss any issues that might have arisen in relation to the implementation of the IOSCO Code;

- Any material incident that might occur with an issuer should be explained to the local securities regulator.

The Code covers three main areas:

- The quality and integrity of the rating process;

- CRA independence and the avoidance of conflicts of interest; and,

The FBF considers the proposed measures 2-8-b and 2-8-c of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies particularly satisfying in order to treat in an appropriate manner the conflicts of interest.

- CRA responsibilities to the investing public and issuers.

This Code currently covers corporate issuers. It should be further extended to include securitization vehicles. That is why the French Banking Federation agrees with the proposal of the IOSCO's consultation report to take into account the notions of "structured product" and "structured finance products", especially in the proposed measures 1-7-3, 1-9-1, 1-14-1 of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies and to determine a special measure for these operations (proposed measure 3-5-1).

IV. ADDITIONAL COMMENTS

The FBF would like to highlight some other points which are handled in the proposed modifications of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

- **Concerning the preference that should be given to self-regulation over regulation, the FBF supports, in substance, the per se project of modified version of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies.**

- Concerning transparency that must be assured for methodologies used in assigning ratings to securitization vehicles and the introduction of changes, and the possibility to compare the methodologies applied by the different CRAs, this is **mainly taken into account in the proposed measures 3-3, 3-8 and 4-3 of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies.**

- The underlying portfolios of securitization vehicles must be monitored so that CRAs can rapidly notify the market of potential deterioration in the assets held by the portfolios.

This is mainly taken into account in the proposed measure 1-9-1 of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies.

- The rating must continue to represent an opinion on the credit risk of an issue and not on market liquidity or price, except when the latter opinions are based on a clearly distinct approach. **The FBF is satisfied as the IOSCO's consultation report tends to support this orientation.**

As the last comments, the FBF would like to highlight two points that had been also highlighted in the report of the Financial Stability Forum on Enhancing Market and Institutional Resilience of the 7th April 2008 addressed to the G7 :

- **Point 4-3 of the above-mentioned report: "*CRAs should demonstrate that they have the ability to maintain the quality of their service in the face of rapid expansion of their activities, and allocate adequate resources to both the initial rating and to the rating's regular review*".**
  The FBF particularly agrees with this point and considers satisfying the proposed measure 1-9 of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies.

- **Point 4-8 of the above-mentioned report: "*Investors should reconsider how they use credit ratings in their investment guidelines and mandates and for risk management and valuation. Ratings should not replace appropriate risk analysis and management on the part of investors. Investors should conduct risk analysis commensurate with the complexity of the structured product and the materiality of their holding, or refrain from such investments*".**
  The FBF considers that this recommendation from the Financial Stability Forum on Enhancing Market and Institutional Resilience is substantially taken into account in the proposed measure 3-5 of the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies proposing to develop a greater understanding by the investors of what a credit rating is and of its limitations.

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April 24, 2008/AdVo

Comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

Dear Ms. Allen,

Your consultation paper provided us with your analysis of the role of credit rating agencies in structured finance markets. Credit rating agencies played an important role in the so-called subprime crisis. It is a common opinion that credit rating agencies did not perform as expected.

Feri Rating & Research AG has not assigned any ratings on structured finance instruments. Therefore we are not in a position to report on any failures in our assessments or in our organization which could provide you with further insights from the perspective of a failing rating agency on how the misjudgments came about. Nevertheless, since you proposed several recommendations for modifying the "IOSCO Code of Conduct Fundamentals for Credit Rating Agencies", we would like to comment to the proposed recommendations, especially because our own Code of Conduct is deeply influenced by these Fundamentals.

Founded in 1987, Feri Rating & Research AG (Feri), with approximately 1,000 customers worldwide, focused on Germany, France and the United Kingdom, is a leading European rating agency specialized in ratings of investment markets and investment products. We are one of the largest commercial economic research and forecasting institutes in Europe. The key feature of Feri's rating procedures is a comprehensive approach with independent analysis and detailed, quantitative market forecasts. In contrast to the big players in the rating markets, Feri is not engaged in the credit rating business. We focus instead mainly on selected rating market niches.

Feri prepares market ratings for industries, countries, capital markets and real estate markets based on deep economic analyses and forecasts. In addition to our global industry analysis, Feri also produces real estate market reports. Our analysis of real estate markets throughout the world is used by our customers to understand property, portfolio, and indirect real estate (open-end and closed-end real estate funds) investment markets.

In the field of investment products, Feri rates investment funds in selected European countries, close-end funds for institutional investors, as well as for retail business, corporations and asset managers. In addition, Feri produces market studies of investment markets. These reports provide an overview of opinions and expected behavior of different kinds of investors.

With more than 60 employees, Feri is based in Bad Homburg, Germany, near Frankfurt, and has additional offices in London, Paris, and New York.

1. General

It is long understood that rating agencies play an important role in financial markets, as their organizations collect expert knowledge about market participants, their products and instruments, financial relations and their evaluation. Without independent assessments of rating agencies, trust and stability in the financial markets would even be more in danger. The current crisis is proof of this. Rating agencies are an indispensable part of modern capital markets and an essential element of the global financial system. This is true not only for the markets of structured finance, but increasingly also for the special market niches Feri is engaged in.

The current crisis demonstrates that the role of rating agencies must be strengthened. Reinvigoration of the rating system must be accompanied with measures to assure that rating markets function well. Governmental and supervisory institutions have vital interest in designing a proper framework for the rating industry.

a) As you write in your consultation paper, the IOSCO CRA Principles are high-level and meant to be used by CRAs of all types and sizes, using all types of methodologies, and operating under a wide variety of legal and market environments. Nevertheless, the Code and Principles seem to be drafted with the paradigmatic examples of leading US rating agencies in mind.

b) Many questions about the quality and independence of structured finance ratings are not meaningful for other types of ratings. Therefore we appreciate a clear-cut border line between issues relating to CRA activities in the area of structured finance ratings and other areas.

c) In general, we feel that the Technical Committee was looking narrowly at issues of credit ratings. IOSCO promotes high standards of regulation not only in the markets for residential mortgage-backed securities (RMBSs) or collateralized debt obligations (CDOs), but in all domestic markets and international securities transactions. Therefore it is legitimate to broaden the scope of the Code to ratings on all kinds of securities and consider implications, e. g. on mutual fund ratings, insurance ratings and other types of rating services provided by rating agencies in all kinds.

d) Specifically, ratings on managed funds, insurance policies and other financial products, which are rated by various rating agencies in Germany and in other countries should be considered. We fear that rules applicable to CRAs could be generalized and in various jurisdictions applied to other sorts of ratings without taking properly into consideration that e. g. ratings for mutual funds differ in many respects from credit ratings on the above mentioned instruments.

The IOSCO CRA Code of Conduct contains more than 50 different provisions to help CRAs guard against conflicts of interest, ensure that their rating methodologies are used consistently by their employees, provide investors with sufficient information that they can judge the quality of a CRA's ratings, and generally help ensure the integrity of the rating process. We encourage the Technical Committee to look at other areas of ratings to assure consistency and general applicability of the Code of Conduct.

2. Current Problems of the Rating Market

The current structure of the rating market could not prevent the current crisis. Transparency of rating processes and methodologies, monitoring of rating performance, CRA staff resourcing, and handling of conflicts of interest are key areas to be covered when reviewing the positive and negative aspects of the current self-regulatory regime, compared with a possible, formal, regulatory regime. Nevertheless, we believe that more attention must be drawn to some basic features of the rating market as it currently exist:

a) Lack of transparency

Ratings were developed and used to increase market transparency. They are a key factor in the decision-making process of investors, shedding light on the opportunities and risks involved in investments. In addition, ratings must allow lenders to identify credit risks in their financing activities. Transparency, public accessibility and insights into the rating results do not meet these standards today.

b) Duopolistic market structure

Dominating roughly 75 % of the global market for ratings of corporations, governments, financial institutions and structured finance, the current duopolistic structure carries with itself all the classic malfunctions known from any textbook regarding the abuse of monopoly status in any market. Yes, CRAs and their ratings played a critical role in the recent market turmoil, as you write in your Consultation Paper, but this resulted not because many investors and market participants effectively outsourced their own valuations and risk analyses of RMBSs and RMBS-backed CDOs to the CRAs in general, but only to the leading two or three rating agencies so that they could become the trigger points for crisis. We assume that the current duopolistic market structure will not protect against future crises and is in fact one of the key reasons for possible crises to come.

c) Lack of research integration

Rating methods are based on more or less extensive research. It is our observation that risks related to a market in its entirety, are not adequately measured by looking only at individual securitizations. The systematic risk from excess valuations and bubbles cannot be captured without an extensive research of the macroeconomic environment.

d) US bias

Currently, the rating systems of the big players represent more or less the US style of financial markets. They do not adequately reflect European attitudes to financial markets. Rating markets in the USA and in Europe do not function in the same way. Even within Europe, product features and behavior patterns are different. This holds true also for individual financial products. This nature of European financial markets must be addressed.

3. Possible Amendments

We believe that significant improvements of rating services can be achieved only by structural changes. First steps for the reinforcement of ratings in the financial markets could be the following:

a) Rating agencies must be obligated to ensure transparency by publishing their fee structure, rating philosophy and methodologies, and how they derive their ratings from facts. Disclosure must be on such a level that meaningful scientific discussions on all relevant issues is possible.

b) At the same time, the influence of investors must be strengthened to ensure that they better understand rating procedures and measures.

c) Analysis and research, which the ratings are based on, must have a higher importance for the investor, in order to give him a better understanding of the rating results.

d) Barriers to market entry are too high for any potential new player. Mechanisms for recognizing rating agencies must be enforced by transparent approval procedures in all countries of your members. This issue cannot be left to the US, as their recognition criteria are very much domestic (see the Credit Rating Agency Reform Act of 2006), and fail to meet e. g. European requirements and norms.

e) In contrast to the segment of structured finance, oligopolistic structures must be avoided in other rating market niches. Competition allows young agencies to develop a rating style meeting domestic and specialized needs. Thus, regulations by a supervisory authority on these markets must guarantee quality, but avoid high market barriers.

We are looking forward to providing you with further details on demand.

Yours sincerely,

Feri Rating & Research AG

Dr. Helmut Knepel

Dr. Tobias Schmidt

(cc: BaFin, Herrn Dr. Jörg Schmidt-Ebeling via E-Mail: joerg.schmidt-ebeling@)

Comment on IOSCO's Consultation Report on Credit Rating Agencies

Summary

The German Insurance Association (GDV) very much welcomes IOSCO's efforts to further improve the effectiveness of its Code of Conduct Fundamentals for Credit Rating Agencies (CRAs). Even though the Code's publication in 2004 – supported by supervisory authorities' monitoring activities – has resulted in significant improvements in CRAs' business conduct, there are still shortcomings in the regulatory framework for CRAs and the Code's objectives have not yet been fully achieved. Therefore, we agree with IOSCO that there is a need for further clarification of the Code's wording and the incorporation of additional provisions into the Code in order to take account of particular issues of concern which are currently not being dealt with adequately in the Code.

Recent turbulences in the markets for structured finance products have highlighted a number of areas in which a revision of the Code is needed. In addition, market participants' experiences with the IOSCO Code in other fields of CRAs' business, e. g. corporate ratings, but also supervisors' earlier monitoring activities and analyses, in particular IOSCO's consultation report of 2007 on the Code's implementation, provide complementary evidence on issues of concern that should be taken into account in deciding on the Code's amendment.

For the German insurance industry, further improvements in the transparency both of rating methodologies and of character and limitations of ratings combined with measures to ensure adequate resources and staff qualification levels at CRAs and to avoid blatant conflicts of interest – as e.g. the case when rating services and advisory services are offered simultaneously – are of greatest importance. In addition to the changes proposed in the consultation report, we believe that a clarification of provision 3.9 on the disclosure of the type of rating (initiation and participation status) must be part of the Code's amendment since CRAs' policies in this area can currently not be regarded as sufficient to achieve the Code's objectives.

Furthermore, in our view, the creation of an arbitration and enforcement mechanism is also necessary in order to ensure full compliance of CRAs with all the stipulations of the IOSCO Code.

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On behalf of the German insurance industry, we would like to thank IOSCO for the opportunity to submit our comments on the consultation paper “The Role of Credit Rating Agencies in Structured Finance Markets” published on 26th March 2008. As the trade association of the German insurance industry with almost universal membership, the GDV represents 455 insurance companies (life, health, property/casualty and reinsurance) with total assets of some EUR 1.2 bn. German insurers use external credit ratings extensively, both in their role as institutional investors and as issuers in the financial markets. In addition, CRAs' ratings are an important element of insurance supervision, and they are also increasingly relied upon by insurance customers. Consequently, the insurance industry depends crucially on high standards in the rating process and on the reliability and quality of the ratings issued by CRAs.

We were in full support of the creation of the current international regulatory regime for CRAs with the publication of the IOSCO Code of Conduct Fundamentals in 2004. We appreciate the valuable work undertaken by IOSCO in this field over the last few years, and we very much welcome IOSCO's current efforts to further improve the Code's effectiveness.

Revision of the Code should take a broad view

Recent turbulences in the markets for structured finance products have again highlighted the importance of well-designed, globally binding minimum standards for the rating business that all CRAs fully adhere to in their policies and daily practices. The deficiencies and shortcomings that have become apparent in the subprime crisis must be addressed, and we share the view that they must be in the focus of the current discussion on necessary adjustments in the regulatory framework for CRAs. In addition, however, we believe that it is important that the Code's revision is based on the whole range of CRAs' activities and market participants' experiences with the IOSCO Code, both with respect to ratings of structured finance products and traditional corporate ratings, but also regarding special types of ratings that can be of great importance in individual market segments, e.g. insurer financial strength ratings. Furthermore, supervisory authorities' preliminary conclusions from earlier monitoring activities and analyses, in our view, also constitute an important contribution to the discussion on necessary changes in the Code.

Achievements and deficiencies of the current regulatory framework

In our view, the IOSCO Code – in the European Union complemented by the monitoring and reporting function which has been assigned to CESR – represents a major step towards closing the regulatory gap which had previously existed in the market for credit ratings. Whereas other institutions or professions that are comparable in their importance to financial markets, e.g. auditors or actuaries, have had to adhere to a wealth of legal standards or professional codes for a long time, CRAs, even under the current regime, are still not nearly as regulated compared with these professions. It is our experience from the German insurance market that as a consequence of the new regulatory regime there have been significant improvements in CRAs' business conduct, e.g. with respect to transparency of methodology and interaction with market participants. However, there are still major shortcomings, and a further adjustment in the regulatory framework is needed. In our comment on IOSCO's earlier consultation report "Review of Implementation of the IOSCO Fundamentals of a Code of Conduct for Credit Rating Agencies" published in February 2007 we already provided extensive evidence from the German insurance market – including evidence from two interactions between the GDV and Fitch – which showed both the effectiveness but also the shortcomings of the current regime.[1] In particular, one important area in which sufficient progress has not been achieved in the German insurance market is the disclosure of unsolicited ratings. We therefore agreed with IOSCO's earlier assessment that the Code needs some clarification, especially with respect to the provision on disclosure of the type of rating (3.9). We also suggested that the creation of an international arbitration mechanism should be considered for cases of disagreement between market participants and CRAs over the interpretation of the Code, as was partly the case in the dispute between the GDV and Fitch.

Current concerns over CRAs' activities only provide additional evidence on the need to further improve the Code

Even though by 2007 supervisory activities together with market pressure had led to further progress in CRAs' codes of conduct and practices, these changes had not sufficiently resolved all prior issues of concern, as we stated in our comment on IOSCO's earlier consultation report in spring 2007. In our view, even if recent developments in the markets for structured finance products have highlighted a number of additional areas in which a revision of the Code is needed, current concerns over CRAs' activities have basically only confirmed our earlier assessment that a review of the IOSCO Code was needed.

From the point of view of the German insurance industry, even though there are some fundamental differences between ratings of structured finance products and "traditional" ratings, the key issues of concern with respect to CRAs' activities in the field of structured finance are basically identical to the concerns regarding "traditional" rating activities, even though there might be some need for special provisions to take account of the particularities of ratings in structured finance markets. In particular, both for ratings of structured finance products and other ratings, sufficient

[1] Our response of 2007 is available on the IOSCO`s website: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD249.pdf. Further details on the interactions between the GDV and Fitch are provided on the GDV's website (introduction of Q-ratings for German insurers in 2004/2005: www.gdv.de/fitch-q-rating; GDV's letter of complaint to Fitch of 2006: www.gdv.de/fitch-gdv-complaint).

transparency of methodology and disclosure of the character of the rating – including its limitations – must be ensured, integrity of the rating process must be maintained, resources and staff qualification levels have to be adequate at all times, and conflicts of interest have to be avoided, or if inevitable, they have to be managed properly.

Action is needed in several fields

One example of conflicts of interest that must be ruled out at all times is the uneasy situation in which the CRA is offering advisory services to a rated entity. We therefore advocate a ban on certain activities by CRAs – e.g. some advisory services – as offered to rated entities. Incidentally, this would only correspond to similar regulation e.g. for auditors. Indeed, in other professions limitations for certain activities are already in place to enhance independence and objectivity. For example, the European Directive on Statutory Audits requires Member States to ensure that a statutory auditor shall not carry out a statutory audit if there is any other relationship including the provision of additional non-audit services.

It is also essential that rating users have access to sufficient information on rating methodologies, e.g. on key model assumptions that might differ from their own assessment or on changes in methodology, so that it is possible to differentiate between rating changes that are due to a change in methodology and rating changes resulting from changes in underlying credit quality. Together with clear information on the type of rating (particularly limitations of a rating, but also participation and initiation status) this would put investors in a position to fully assess the quality of a rating and its reliance for their investment decisions. Even though there have been significant improvements, and in many cases extensive information is provided by CRAs, so far, sufficient information is not always easily available. Another important area in which there is ample scope for improvement by CRAs is human resources. It is of utmost importance that sufficient numbers of experienced staff are available at CRAs to maintain the quality of ratings and to allow regular monitoring of ratings and timely rating revisions in case of a change in credit quality. Whereas for other professions, e.g. auditors or actuaries, specific qualification standards have existed for a long time, there are as yet no comparable standards for rating analysts. Although we believe that CRAs do make efforts to ensure sufficient staff levels and qualifications, our experience is that especially in market segments in which there is rapid expansion of rating activities, shortages in experienced staff occur.

In sum, profound strengthening of the current regulatory framework is necessary in order to ensure that CRAs can fulfil their role in the financial markets and distortions both in the market for ratings and in the financial markets are to be avoided in the future. In our view, the most important regulatory measure is the amendment of the IOSCO Code, since considering the global character of the rating business and of financial markets an international approach is required to address current shortcomings.

Additional proposal for an amendment of the IOSCO Code: Clarification on disclosure of the type of rating

Currently, many provisions of the Code contain general guidelines only and the wording is often ambiguous. To the extent that the Code's provisions have proved insufficient or not clear enough, alterations are clearly needed in order to reduce the scope of interpretation and to include additional aspects that have been identified in the meantime as being vital for the quality of ratings.

In addition to the proposals in the consultation report, from our viewpoint, an amendment of the Code should also comprise a clarification of the required minimum standards with respect to disclosure of the type of rating (provision 3.9). The clarification of provision 3.9 was also proposed in IOSCO's consultation report of February 2007 and was supported by market participants in the subsequent consultation. Similarly, in its report to the European Commission of January 2007, CESR came to the conclusion that there is a need for improvement in CRAs' policies in this field. For the German insurance industry, the issue of disclosure of the type of rating is of particularly high importance since unsolicited and mostly non-participating ratings are widespread in the German insurance market. Indeed, for German insurers, the number of unsolicited ratings even exceeds the number of solicited, fully interactive ratings. Hence, full disclosure of the initiation and participation status of a rating is essential in order to avoid distortions both in the German insurance market and in the market for ratings.

Therefore, we would like to propose that in provision 3.9 an unequivocal statement is added to the effect that disclosure of the type of rating has to be self-explanatory at any time a rating is published, so that it is made clear that rating users must have immediate access to this information and cannot be referred to sources of information available only separately from the rating information itself, e.g. by contacting the CRA or accessing special reports on the CRA's website. Provision 3.9 could, for example, be amended as follows (insertion underlined):

> For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. <u>Clear and unequivocal information on both initiation and participation status should be provided whenever a rating is quoted or referred to in public, for example in press releases or on the CRA's website.</u> The CRA should also disclose its policies and procedures regarding unsolicited ratings.

Creation of adequate arbitration procedures and enforcement mechanisms

In our view, an important shortcoming of the current system is that there is no arbitration or enforcement mechanism to guarantee CRAs' compliance with the IOSCO's provisions. Though in many cases market pressure and moral suasion by supervisory authorities is sufficient for CRAs to amend their practices, this is not always the case, and sometimes cases of disagreement between market participants and CRAs over the interpretation of the IOSCO Code cannot be resolved.

Under the current regime, even when there is a broad consensus among market participants and supervisors that a CRA violates a certain provision of the Code and, moreover, there is ample evidence that the Code's objectives are not achieved by the respective CRA, there is no way to force this CRA, which might insist on a different interpretation of the provision in the IOSCO Code or claim to exercise a legitimate right to deviate from the Code, to change its approach. This problem is aggravated by the oligopolistic market structure, which means that market participants are often not in a position to rely on other providers of rating services instead.

Therefore, some arbitration and enforcement procedure is required in order to further enhance CRAs' adherence to the Code in the sense that ambiguities cannot be exploited by CRAs or that CRAs cannot claim that they comply while in fact their business conduct is in contrast to the Code.

There would be various possibilities to create an arbitration mechanism. In our opinion, an international approach would be advantageous since it guarantees a globally consistent interpretation of the Code's provisions. For example, it might be possible to charge the same body at IOSCO that has drafted the Code and is currently working on its amendment with resolving arbitration appeals. Alternatively, an international committee could be created at IOSCO level consisting of representatives from supervisory authorities, market participants and CRAs. A further option would be to assign the arbitration and enforcement tasks explicitly to supervisory authorities in the respective countries or regions (CESR in Europe) which, however, would have to co-ordinate their approaches.

Outlook on IOSCO's future role

As the effectiveness of any amendment of the IOSCO Code can only be fully judged upon after some years during which additional experience will have been gathered, in addition to the changes to the Code resulting from the current review, further amendments of the Code's provisions might prove necessary in the future should it become apparent that the objectives of the Code are not or not anymore achieved sufficiently.

In our view, beside a full review process every few years, it might be desirable that IOSCO monitors developments with respect to the Code on a regular basis. For example, IOSCO could invite market participants to inform IOSCO about questions and disagreements with respect to a CRA's implementation of the Code. In this case, IOSCO might also assume the role of an ultimate arbitration body.

Berlin, 25th April 2008

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25th April 2008

Dear Kim

IBFed response to IOSCO's Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets

The International Banking Federation (IBFed) welcomes the opportunity to comment on the IOSCO's Consultation Report on the role of Credit Rating Agencies (CRA) in structured finance markets. IBFed has consistently supported IOSCO in its work on updating the Code of Conduct for Credit Rating Agencies ("the Code") in response to the ongoing financial turmoil as we feel that the Code offers, appropriately, a degree of flexibility that is very necessary in uncertain market conditions as those we are experiencing today.

General comments

In general, we find the report to be informative regarding the role of CRAs in the structured finance market. We also agree with many of its proposed revisions to the Code and are positive that these revisions would improve the credit rating process for structured products and help to restore confidence in CRAs' role in these markets.

Ratings are not a substitute for investors' own risk assessment and CRAs should not be held responsible for inappropriate decisions by investors. At the same time, the financial market turbulence and the perceived failure by CRAs to give sufficient early warning of the problems in structured finance vehicles have indeed demonstrated the need to assess CRAs' practices with regard to a number of aspects.

In addition to this, we also want to emphasise the significance of competition in the CRA market. As the market adapts to the revised Code, we would urge the IOSCO to continue to monitor concerns around the oligopolistic market situation and its potential effects as regards CRAs' incentives to improve the quality of their ratings.

Specific comments

Quality and Integrity of the Rating Process

We broadly agree with the IOSCO's recommendations in this respect. As regards the IOSCO's recommendation 7, prohibiting CRA analysts to make proposals or recommendations on the design of structured finance products rated by the CRA, we underline however that the securitisation process is of an iterative nature. Close interaction between CRAs and issuers in that process is critical to e.g. determine the appropriate level of credit enhancement for the different tranches of the product. This interaction is also not problematic in our view so long as the CRA's rating methodology and criteria remain fully independent of that interaction. It should therefore not be prohibited by recommendation 7, nor do we believe that this activity should be considered an ancillary business activity. For example, we consider it legitimate that the CRA communicate to the issuer, originator or underwriter the consequences of its packaging decisions.

However, we believe that increased transparency and disclosure of CRAs towards the markets with regard to this interaction would be helpful and would allow investors to consider CRAs' internal functioning in their decisions on which CRAs to rely on.

Whilst we concur that CRAs should not rate instruments for which its models and methodology are not suitable, we note that this must not prevent CRAs from developing their methodologies further in line with market developments. For example, where CRAs are using new approaches they should indicate this together with the possible limitations of the rating, rather than to refrain from providing a rating at all.

CRA independence and avoidance of conflicts of interest

IBFed agrees, again, with the proposed amendments to the Code of Conduct. We reiterate that credit enhancement analyses should not be considered an ancillary business.

We would furthermore propose that if CRAs are to publish any institution that is more than 10% of revenue, it should be done on an annualised basis of total revenue across the CRA. This is on the basis that market conditions such as the current ones may distort this measure as there are only a limited number of larger deals being done. This also somewhat of a blunt instrument and is likely to create a ceiling for firms to avoid going over 10%.

CRA responsibilities to the investing public and issuers

We agree with IOSCO's proposals for more information to be provided on the meanings and limitations of credit ratings. This should in our view not be done as a simple disclaimer, but with more comprehensive but at the same time, clear and easily accessible information. While the information to be disclosed will increase the regulatory costs of operating a CRA, we believe, on balance, that those costs are justified, especially as the Code permits the CRA to disclose the reasons for their non-compliance with any provision of the Code.

A close link exists between this general information and the use of different methodologies. Some key information should also be provided on the assumptions behind different methodologies, such as the general market environment, where possible an indication as to the degree of assumed continuity of some key aspects of the ratings, and the correlation with other market factors or instruments.

Such a description of the meaning and limitations of ratings is in our view more important and of more practical use to investors than the use of different rating scales. This should for example also point to the specific nature of the risks of structured finance products, such as the correlation risks and model risks. It should at the same time be combined with more specific information on the underlying assumptions of individual ratings. Indeed, we share the concerns that the use of different rating scales might be confusing to investors and even be misunderstood to imply that the different risks of structured products as compared to corporate bonds are reflected in the rating.

The meaning of a rating should therefore be consistent across asset classes, as far as possible. Investors should in addition be encouraged to fully consider the background of the ratings and be aware of the need to make their own assessment of the risks involved in the products and markets for which they consider an investment.

In this context, we would suggest that in addition to general information to be provided on the use of methodologies and methodology versions, CRAs be required to disclose when a rating upgrade is as a result of changes to the methodology, rather than the fundamentals of the product or market environment.

However, we have some reservations with regard to point 14 of disclosures on cases where the issuer has an indication for a rating or a final rating from a CRA, but decides not to make use of it or not to publish it. Such a statement will always be interpreted as an indication that the product would have received a less favourable rating with the CRA whose services were not used. Yet, there can be other reasons for an issuer to choose another CRA, for example with regard to the quality of the CRAs' work, in which case the statement would be both unjustly damaging to the issuer and misguiding for the investor. On a more general note, we also observe that the concern of 'ratings shopping' might be less acute as a result of the limited competition that exists in the market.

Disclosure of the Code of Conduct and communication with market participants

We agree that CRAs should publish in a prominent position on their homepages links to their Codes of Conduct, to a description of the used methodologies, and to historic performance data. As noted above, CRAs should be encouraged to ensure that this information is provided in a meaningful way for investors. Most desirably, it should enable investors, where possible, to conduct comparisons between the CRAs not only in terms of historical performance, but also as regards key differences in the assumptions on which the ratings rely.

Summary and conclusion

The IOSCO's approach is overall balanced and suitable to ensure significant improvements in CRAs' role in the structured finance markets, as well as to restore confidence in CRAs in general. Care must however be taken to recognise the iterative nature of the rating of structured finance products, which is legitimate so long as the independence of CRAs' methodologies is fully safeguarded. Rather, the emphasis should lie on enhanced transparency and disclosure around the ratings process, combined with clearer and more targeted information to investors.

We trust that you will find the comments in the letter to be helpful in advancing IOSCO's proposals for amendments to the Code. We remain at your disposal for any further input you require in relation to this or any other issues.

Yours sincerely,

Sally Scutt
Managing Director
IBFed

Pierre de Lauzun
Chairman
IBFed Financial Markets Working Group

INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

April 25, 2008

Ms. Kim Allen
IOSCO General Secretariat
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Spain

Re: Comments on IOSCO's Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets

Dear Ms. Allen:

I am writing on behalf of the members of the Standing Committee on Regulatory Affairs of the International Council of Securities Associations ("ICSA") which is composed of the trade associations and self-regulatory associations active in the majority of the world's major securities markets.[1] We would like to thank the members of IOSCO's Task Force on Credit Rating Agencies for the work that they have done to produce *The Role of Credit Rating Agencies in Structured Finance Markets, (*"the Report"*).* We welcome the opportunity to comment on the Report.

In general, ICSA members support the proposed changes to IOSCO's Code of Conduct for Credit Rating Agencies that are proposed in the Report. Credit rating agencies (CRAs) play an extremely important role in capital markets, and therefore it is critical that investors and regulators are confident in the work done by the CRAs. We agree with the analysis in the Report that the recent market turmoil and perceived weaknesses in ratings have given rise to legitimate concerns regarding the credit rating agencies, including concerns about their methodologies and potential conflicts of interest. We believe that the modifications suggested to IOSCO's Code of Conduct will, on the whole, contribute to a rebuilding of confidence in the CRAs.

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[1] The members of the International Council of Securities Associations (ICSA) represent and/or regulate the overwhelming majority of the world's equity and fixed income markets. ICSA's objectives are: (1) to encourage the sound growth of the international securities markets by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members.

At the same time, although ICSA members support the vast majority of recommendations contained in the Report, there are some proposed additions to the Code of Conduct for Credit Rating Agencies that we find either too vague, and therefore in need of greater clarification, or which we do not agree with. Those specific sections are detailed in the Annex to this letter.

In closing, ICSA members would once again like to thank the members of IOSCO's Task Force on Credit Rating Agencies for their work in preparing the Report. We welcome the opportunity to comment on the Report and look forward to further discussing the issues contained in our letter with IOSCO members.

Sincerely,

Jonathan Taylor, Chairman,
ICSA Standing Committee on Regulatory Affairs
and Director General, London Investment
Banking Association (LIBA)

Annex: Specific Comments by ICSA's Standing Committee on Regulatory Affairs on IOSCO's Consultation Report regarding the Role of Credit Rating Agencies in Structured Finance Markets

I. Quality and Integrity of the Rating Process

1.7 *The CRA should adopt reasonable measures to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating.*

ICSA members are generally sympathetic to the notion that CRAs should ensure, to the greatest extent possible, that the data used for their analysis is of the highest quality possible. While, as drafted, the wording of this paragraph does not add significantly to the normal standards of care to which a CRA should be held, we are concerned that its inclusion carries with it an implication that CRAs would have a more onerous obligation imposed on them for structured products than for corporate credits and one with which it would be extremely difficult to comply. As is pointed out in the Report itself, CRAs "…traditionally do not confirm the accuracy of much of the information provided to them by issuers, who maintain ultimate responsibility for the accuracy of the information they provide to the market". We are therefore concerned that paragraph 1.7 could be taken to require the CRAs to assume the role of auditor of a structured product, with the attendant costs and legal uncertainties. We believe that the obligation for ensuring the quality of the data that the CRA's receive for purposes of rating structured finance products should continue to rest with the issuer, as is the case for the corporate and sovereign credits that the CRAs rate.

1.14-1 *A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.*

We would strongly urge the members of the IOSCO Task Force on Credit Rating Agencies to review the wording that they have used in this paragraph, since we ourselves are not really sure what it means.

For example, some members of the ICSA Standing Committee on Regulatory Affairs believe that paragraph 1.14-1 would essentially prohibit CRAs from providing advice on the structuring of a product and rating the same structured finance product. Other members of the Committee believe that paragraph 1.14-1 is meant to ensure that there are appropriate Chinese walls between the employees of a CRA that are involved in giving advice on structuring a given structured finance product and the employees of the CRA that are involved in rating that structured finance product. If the latter were the case, it would make the revised Code of Conduct for CRAs consistent with already established policies as published by S& P and we are led to believe as followed by other leading other CRAs.

Moreover, paragraph 1.14-1 leaves unresolved a fundamental issue as to what constitutes advice. As the Report notes, the individual performing the ratings analysis for the CRA carries out a loss analysis to determine how much credit enhancement a given tranche security would need in order to get a particular credit rating. For that reason, as the Report also notes, the ratings process for a structured financial product differs significantly from the ratings process for a corporate bond since in a structured finance transaction, "… the CRA provides the investment bank with input into how a given rating could be achieved (i.e., through credit enhancements)."

The Report then also notes that:

> The serious question that has arisen is whether the current process for rating structured finance involves advise that is, in fact, an ancillary business operation which necessarily presents a conflict of interest. Conversely, while some observers believe that the structured finance rating process does not necessarily pose an inherent conflict of interest vis-à-vis the CRA's rating business more generally, the further question is whether a CRA has sufficient controls in place to minimize the likelihood that conflicts of interest will arise.

We agree that these are relevant considerations but, as noted above, we believe that paragraph 1.14-1 does not sufficiently clarify the issues and instead may add to the confusion.

Regarding how conflicts of interest within the CRAs should be addressed, some ICSA members would support paragraph 1.14-1 if the paragraph were meant to ensure that there were appropriate Chinese walls between the employees of a CRA that were involved in structuring a given structured finance product and the employees of the CRA that were involved in rating that structured finance product. Those associations believe that the CRAs are capable of maintaining sufficiently strong Chinese walls so that they could appropriately manage any conflict of interest that might arise if they were to both advise on and rate the same structured finance product.

On the other hand, some ICSA members would support paragraph 1.14-1 if it meant that CRAs would be prohibited from advising on the structuring of a given structured finance product and also rating that same product. Those associations believe that CRAs will not be able to appropriately manage the conflicts of interests that would arise if the CRAs were able to both advise on and rate the same structured finance products. Therefore, in order to restore the credibility of the credit rating agencies, they believe that it is necessary to ensure that individual CRAs are not able to advise on and rate the same structure finance products.

Regarding the definition of advice, many ICSA members believe that the process described in the Report, in which the ratings analyst is able to inform the sponsor regarding the rating that the structured finance product would receive – which in turn would allow the sponsor to adjust the structure if necessary in order to strengthen the rating – is separate from the advice that may be given at an earlier stage by other employees of the CRA that are involved in the structuring process. These ICSA members do not view feedback on rating scenarios as 'advising' but rather as providing facts on how the rating methodologies are being applied and on how specific changes in the structure would affect the ratings. If a prohibition were placed on the ratings analyst so that he or she could not inform the sponsor of the need for specific credit enhancements, these ICSA members are concerned that the result would be an expensive and time consuming delay in the entire process, as the sponsor would not find out that there was a need for additional credit enhancements until the ratings committee had reached their final decision.[2] In that case, there is a real risk that the process of rating structured finance products would become too costly and time consuming for sponsors. It could, as a result, effectively extinguish or severely limit the supply of new structured finance products with a senior investment grade rating.

Some ICSA members, on the other hand, believe that in order to ensure that conflicts of interest within CRAs are completely controlled there should be a complete prohibition on all conversations between the ratings analyst and the sponsor.

Given the potential implications of paragraph 1.14-1, we believe it is imperative that IOSCO clarify this provision.

3. CRA Responsibilities to the Investing Public and Issuers

3.5 b The CRA should disclose whether it uses a separate set of symbols when rating structured finance products, and their reasons for doing so or not doing so.

As it is written, paragraph 3.5b is not controversial as it would only require CRAs to disclose if they used or did not use a separate 'symbology' for the structured credit products that they rated compared to the corporate credits that they rated. However, the Report itself also states that, as part of the consultation process, "…the Technical Committee seeks public comment on the desirability of using a different set of rating symbols to differentiate structured finance ratings from ratings of corporate debt securities."

[2] The situation would become even more complicated if the decision could only be given by a rating committee of a second CRA, which could not itself provide advice as to how to achieve a higher rating, which is one interpretation of 1.14-1. In that case, the stage would be set for passing the structure backwards and forwards between the two CRAs until the desired result were achieved.

In this specific area there is a difference of opinion among ICSA members. Some ICSA members believe that the CRAs should adopt separate 'symbols' for structured credit products compared to corporate credits because there is such a fundamental difference between a corporate or sovereign entity and the bundle of assets that lie beneath a structure finance products can behave. For example, a corporation has the ability to change its policies in response to a crisis, which in turn will affect its ability to service its debt. Indeed, part of the rating process for a corporate or sovereign entity includes an assessment of the quality of its management. The issuer of a structured finance product, on the other hand, even where the underlying portfolio is actively managed, generally has minimal ability to respond to a change in external circumstances.

On the other hand, a number of ICSA members argue that it would be inappropriate to adopt a separate 'symbology' for structured finance products. These associations do not believe that a separate notation would address the issues surrounding investor reliance on ratings, which appear to be at the heart of the authorities' concerns. A more appropriate response to that concern would be to improve the information that is provided to investors with the rating, for example by including information on the likely volatility of the rating and the factors that would influence that volatility. In addition some ICSA members believe that introducing a separate 'symbology' for structured credit products at the current time could further stigmatize those instruments at a time of low investor confident and highly illiquid markets. For example, in those jurisdictions which impose investment restrictions on certain institutional investors for securities below investment grade, it would call into question whether highly rated structured products under a new 'symbology' could continue to be invested in without limit. The result could be a further deterioration in credit markets, with consequent pass-through effects to the real economy.

Finally, we would note that the Financial Stability Forum (FSF) has recently recommended that credit rating agencies should differentiate their ratings on structured credit products from those on corporate credits. In addition, the FSF has also recommended that regulatory authorities should review their use of ratings in the regulatory and supervisory framework. Given these recommendations, some ICSA members believe that the fundamental regulatory issues underlying the use of ratings within the regulatory system should be resolved first, before any decision is made on the need for a separate set of ratings for structured credit products. Once that is accomplished, these ICSA members would suggest that the answer to the question regarding whether or not there should be a different 'symbology' for structured credit products would emerge naturally.

CONFIDENTIAL
April 8, 2008

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Ms. Kim Allen
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Dear Madam:

The IIF Ratings Process Issues Working Group (the "Working Group") is pleased to submit written comments on the "IOSCO Technical Committee Consultation Report on Credit Rating Agencies" issued in March 2008. The Working Group is part of the IIF Committee on Market Best Practices (the "Committee")[1] that was convened in response to the strains that originated from the deterioration of the US subprime mortgage market. The objective of the Committee is to arrive at broad agreement and commitment to implement changes in business practices to address weaknesses in the form of best-practice recommendations or possible codes of conduct.

While some rating agencies have participated in the work of the Committee, the IIF's comments on the IOSCO Consultation Report should not be taken to represent the views of any credit rating agency. The rating agencies note that they are working actively with the Working Group and others, including regulators, on measures they believe will enhance their processes and increase transparency. The Committee shares the hope that the rating agencies and the financial institutions will continue to work together and find common ground on these issues.

Our comments on your paper are based on the findings of the Working Group, which has analyzed the rating of asset-backed structured products from origination to risk assessment of securities by the rating agencies and the assignment of final ratings. Further, it has considered what due diligence is carried out on underlying borrower quality, the possible conflicts of interests in the firms and the rating agencies, as well as the amount of information disclosed. Discussions have also been carried out with some institutional investors to canvas their issues.

We welcome your report and support the need to modify the IOSCO CRA Code of Conduct in the light of the recent market turmoil.

We approach the Consultation Report from an international perspective and while the Institute, in this comment letter will not address every recommendation, members may do so in their own comments.

[1] The Committee, chaired by Rick Waugh, President and CEO, Scotiabank; and Cees Maas, Honorary Vice-Chairman and Former Chief Financial Officer, ING, has established five Working Groups to address the most relevant issues to the market stress: **Risk Management and Credit Underwriting Practices,** chaired by Koos Timmermans, Executive Board and Chief Risk Officer, ING; **Conduits and Liquidity Risk Issues,** chaired by Bob Brooks, Vice-Chairman and Group Treasurer, Scotiabank; **Valuation Issues**, chaired by Darryll Hendricks, Managing Director and Global Head of Quantitative Risk Control, UBS; **Ratings Process Issues**, chaired by Patricia Jackson, Partner, Ernst & Young; and **Transparency and Disclosure**, chaired by Didier Hauguel, Chief Risk Officer, Société Générale.

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April 8, 2008

Quality and Integrity of the Ratings Process

Modification 2: CRAs should establish an independent function responsible for periodically reviewing both the methodologies-and-models and the changes to the methodologies-and-models used in the rating process.

The Working Group agrees with IOSCO that there needs to be more scrutiny of the ratings methodologies-and-models. The Working Group finds that although rating agencies make their models available to investors, without detailed underlying loan-back data from the banks, additional information on stress testing and the underlying assumptions of the model, it is not possible for investors to verify the accuracy of the ratings models. Although it would be beyond the capacity of many investors to validate independently the rating agency models, more information would help sophisticated investors. Nevertheless, for many investors the ratings models will remain a black box, and even for sophisticated investors full validation will remain difficult.

Therefore, the Working Group suggests that to regain investor confidence in the ratings process there is a need to establish a mechanism or process that would ensure independent review of the methodologies, models and internal governance processes of rating agencies. This should cover independent model validation, independent monitoring with the models being rerun on up-to-date data on the performance of loans in the pools. The ratings need to reflect all relevant risk factors including the lending standards and frequency of sampling of borrower documentation. There needs to be clear documentation of all these aspects and the choice of the risk factors and assumptions.

It proposes that industry standards should be developed regarding the governance, monitoring and independent validation of models within the rating agencies. The agencies would have external audit of their processes relative to these standards. The agencies would attest that they met the standards laid down.

The Working Group is of the view that models should be externally validated against the standards – but it should be emphasized that there would be no intent to harmonize them across agencies, nor to validate rating outcomes. The results would be communicated to the appropriate oversight bodies in the rating agencies, not to the public.

Modification 4: CRAs should ensure that the CRA employees that make up their rating committees (where used) have appropriate knowledge and experience in developing a rating opinion for the relevant type of credit. AND

Modification 8: CRAs should ensure that adequate resources are allocated to monitoring and updating its ratings.

The Working Group fully supports this modification and believes it is important that rating agencies have a sufficient amount and quality of resources to fulfill their roles.

Modification 7: A CRA should prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.

The Working Group fully supports this modification.

CONFIDENTIAL
April 8, 2008

CRA Independence and Avoidance of Conflicts of Interest

Modification 11: A CRA should disclose whether any one issuer, originator, arranger, subscriber or other client and its affiliates make up more than 10 percent of the CRA's annual revenue.

The Working Group recognizes that the growth of securitized transactions and structured finance has provided strong revenue incentives for rating agencies. The fact that the rating agencies are paid by the originators and issuers of securities rather than investors has raised questions about the integrity of the ratings system, although many feel that alternative payment structures such as payment by investors (if practical) would create other potential conflicts.

Given the problem of conflicts, it is essential to strengthen oversight and governance of models and analytic processes within the ratings agencies to address them. Therefore, the Working Group supports this modification and also suggests that the fee for a particular rating (relative to set ranges) should be disclosed in the offer document.

CRA Responsibilities to the Investing Public and Issuers

Modification 13: A CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the limits to which it verifies information provided to it by the issuer or originator of a rated security.

The Working Group found that many investors rely on the ratings of structured products when making investment decisions and rely on investment mandates where the rating is the paramount feature. It believes that there is a need to develop Market Best Practices for investors, which will help reduce excessive reliance on ratings and enable investors to consider additional criteria in their investment decision-making process. As part of the final report, the Working Group will recommend Market Best Practices for investors that can be adopted by all investors. For example, the Market Best Practices might suggest that investors, making use of enhanced disclosures such as:

- *Understand vehicles and structured products clearly,* including the position of rated tranches and cash flows in the structure.
- *Conduct their own due diligence* before investing in a structured product by considering the material triggers and their effect on volatility and liquidity, information on stress testing carried out by rating agencies, and taking into account the quality of the underlying assets, degree of transparency of the overall structure and underlying exposures and their future liquidity.
- *Monitor data released on ongoing performance* of the underlying pool and information from rating agencies on the performance of ratings.

On a related issue, in order to facilitate more informed use of credit ratings, the Working Group is assessing the feasibility of introducing a one-page summary of risk factors for different types of structured products in the prospectus. This would have two important functions: first, it should help investors identify key risk drivers, enabling them to evaluate the risks of structured products; and second, it should provide investment committees with reference points in addition to ratings that could be used in investment mandates.

The Working Group is also looking at the feasibility of standardized offer documents for various structured products. Some offer documents are as long as 2,000 pages making investor assessment difficult and if such an approach were adopted by the industry, changes to the standard structure in the offer document would be highlighted to alert investors to any unusual terms. Information in offer documents should be enhanced to include quantitative information on underlying pools such as exposures by Probability of Default (PD) band and weighted average Loss Given Default (LGD). There is also a need to provide more clarity on structures and default or acceleration triggers and the implications thereof.

Modification 15: A CRA should publish verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs. AND

Modification 16: Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.

The Working Group agrees that greater clarity needs to be provided regarding the target behind the ratings (the definition and probability of default). More focus by all agencies is needed on loss given default, which has been fundamentally different in different structures.

Also, more clarity should be provided regarding the factors that could lead to a downgrade. On individual securities, more information is needed on the assumptions lying behind the rating models and the sensitivity of the outcomes to small changes in assumptions, for example on correlation, as well as the stress tests. This would be particularly important for some of the synthetic structures. Sensitivity to events affecting the triggers should also be set out.

Modification 17: A CRA should disclose whether it uses a separate set of rating symbols for rating structured finance products, and its reasons for doing so or not doing so. In any case, a CRA should clearly define a given rating symbol and apply it in the same manner for all types of products to which that symbol is assigned.

There is a growing consensus to reconsider current rating scales and therefore the Working Group supports exploration of different or additional rating scales for structured products (compared to debt). There is interest in separate or additional rating scales on the part of many in the industry and in the official sector, although not all share this view. Efforts including by rating agencies to obtain and evaluate feedback from market participants on the idea of separate or additional scales should be continued. Whatever approach is finally developed, the Working Group underscores the need for rating agencies to better articulate the various factors that are taken into account when considering a rating and provide additional information pertaining to risk attributes in addition to credit risk such as volatility and migration risks.

The IIF Ratings Process Issues Working Group wishes to thank you for the opportunity to submit these comments. We hope that the foregoing comments are useful to IOSCO.

Should you have any questions, please do not hesitate to contact the undersigned or Rakhi Kumar, Policy Advisor of the Institute's Capital Markets and Emerging Markets Policy Department, at 1-202-857-3650, email: rkumar@iif.com.

Very truly yours,

Hung Tran
Senior Director
Capital Markets and
Emerging Markets
Policy, IIF

Patricia Jackson
Chairperson
IIF Ratings Process Issues Working Group

International Investment Funds Association
Association internationale des fonds d'investissement

April 24, 2007

Mr Michel Prada
Chairman
IOSCO Technical Committee
C/ Oquendo 12
28006 Madrid
Spain

Re: Follow-up to the Paris meeting with IOSCO Technical Committee

Dear Mr. Prada:

The INTERNATIONAL INVESTMENT FUNDS ASSOCIATION (IIFA)[1] would like to thank the IOSCO Technical Committee for inviting representatives of IIFA members to the meeting held in Paris on 20 March 2008.

The recent dialogue launched by IOSCO on recent market events and on IOSCO Work Programme is of crucial importance to us. We want to stress that several topics identified by the IOSCO Task Force on the subprime crisis (TFSC), are of direct interest for investment funds.

Regarding the Work Program of IOSCO, we welcome SC5's plan to schedule regular Open Hearings on strategic industry topics and we look forward to bringing the experience of our members to the discussion.

With regard to the IOSCO consultations on the role of Credit Rating Agencies and the Joint Forum Consultation on Credit Risk Transfer, although these topics are of significant importance to IIFA members, we are unable to provide IIFA comments, due to the short consultation period. Nevertheless, the consultations were made available to members and some member associations may directly respond to you.

[1] The INTERNATIONAL INVESTMENT FUNDS ASSOCIATION (IIFA) represents at worldwide level the investment management industry for collective portfolio management. Members and participants to the IIFA include 35 domestic associations from all regions (Americas, Europe, Asia, Pacific, Africa). Together, they manage more than 24 trillion US dollars or 16 trillion euros in the field of investment management. In terms of funds range, our industry includes mutual funds, UCITS and also a part of employee savings schemes funds, regulated hedge funds/funds of hedge funds and private equity funds.

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International Investment Funds Association
Association internationale des fonds d'investissement

Although we understand the current IOSCO timing constraints, IIFA is a worldwide association. IIFA is currently composed of 35 national associations, each with differing regulatory regimes and a rigorous policy making process which must be taken into account before IIFA can consider responding to a consultation.

We recommend that IOSCO provide longer comment periods in circumstances where the consultation raises complex issues that implicate a range of stakeholders around the world in different ways. A longer comment period would allow interested parties, including associations, to deliberate and prepare analysis and comments on the topics at stake. We believe that longer timelines are a prerequisite to improved dialogue between IOSCO, IIFA and the individual investment fund associations around the world.

We trust that the above will be of help to the Technical Committee and its working groups. A copy of this letter is also being sent to the respective consultation groups on Credit Rating Agencies and Credit Risk Transfer. We hope to exchange views with IOSCO representatives on these important topics in the future.

Please feel free to contact the undersigned (rgilbert@ifsa.com.au), Joanne Vezina at our support office (iifa@bellnet.ca) , or Stéphane Janin, the Chair of the IIFA-IOSCO working committee (s.janin@afg.asso.fr), to make arrangements in that regard.

Sincerely,

Richard Gilbert,
Chief Executive Officer
Investment and Financial Services Association, Australia
And
Chair, International Investment Funds Association

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Investment Management Association

24 April 2008

Ms Kim Allen
IOSCO General Secretariat
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28006 Madrid
Spain

Dear Ms Allen

IOSCO Technical Committee Consultation Report on Credit Rating Agencies

The IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail and investment banks and life insurers, and the managers of occupational pension schemes. They are responsible for the management of over £3 trillion of assets (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds such as pensions and life funds and a wide range of pooled investment vehicles.

The IMA appreciates the opportunity to respond to IOSCO's Consultation Report on The Role of Credit Rating Agencies in Structured Finance Markets. In managing assets for both retail and institutional investors, IMA members are users of the capital markets and users of information provided by/on companies. The IMA does not represent its members as corporates, and as such our views are the unconflicted voice of the buy-side.

While IMA members are significant investors in bonds and therefore review ratings assigned by credit rating agencies as part of their investment process, their exposure to structured products is minimal. Credit ratings, however, are heavily relied on to describe asset allocation in client mandates or fund definitions. Moreover regulators are adopting ratings into some of their rules, which means they ought to have a considerable interest in transparent and robust practices. The IMA therefore does have a keen interest in the functioning of credit rating agencies in general and in particular how they manage their conflicts of interest.

Regarding IOSCO's proposed changes to the Conduct Fundamentals for Credit Rating Agencies, the IMA supports the suggested amendments. In particular the IMA considers that the proposed requirement in CRA Procedures and Policies 2.8.c is an interesting development and however it may be finally formulated, the principle behind it may increase confidence in the integrity of ratings.

With respect to the issue of a separate system of symbols for structured products as opposed to corporate bonds, the IMA believes that it is worthy of serious consideration. While there is a risk that this may only serve to confuse investors, and that a different symbology might suggest to the less sophisticated that the rating process for each type of product might be addressing different issues, not just default risk and loss characteristics, it seems to be clear that ratings on structured credit are inherently less stable than on corporate bonds. This is due to their reliance on mathematical modelling using questionable assumptions of default correlation and because their structures are akin to an object with a high centre of gravity i.e. given a slight push it easily falls over. Should the majority of market participants responding to the IOSCO consultation support the adoption of a separate system of symbols by the CRAs, then the IMA urges that the decision is evidence based and that it be carefully market tested.

The IMA also encourages regulators and standard setters to co-ordinate any action they may take regarding CRAs.

More specific points of relevance to IOSCO's paper were provided in the IMA's response in March to CESR's consultation paper on The Role of Credit Rating Agencies in Structured Finance and are summarised as follows:

i. IMA members believe that the self-regulatory regime introduced in 2005 whereby CRAs would voluntarily comply with the IOSCO Code of Conduct has led to an improvement in transparency in the corporate bond market.
ii. IMA members view the agencies' ratings as just one opinion amongst many which they assess when coming to an investment decision. The rating of a bond, moreover, does not actually tell the investor anything about the value of the instrument at any point in time. One member commented that the use of ratings in asset management is "very old-fashioned".
iii. It is important to distinguish between the ratings process for corporate bonds and that for structured finance. The former has more integrity in that it is based on the analysis of a specific company. Structured finance however relies on mathematical modelling of expected default rates and correlation of default within the underlying asset pools. These models have clearly proved to be flawed. In addition the rating of structured finance is a repeat business hereby the issuers will bring regular business to the CRAs, in contrast to the rating of corporate bonds where the business is more sporadic.
iv. There is over-reliance on credit ratings as an objective standard of quality:
    - By investors who do not have access to unconflicted credit analysts (in contrast UK-regulated asset managers who commonly have a team of their own analysts);
    - In investment regulations and also less-sophisticated investment mandates which draw absolute distinctions between investment-grade and other instruments;
    - In capital regimes, and unsophisticated models based upon them; and
    - More generally, as for example where the UK Water Regulator (Ofwat) imposes a licence condition upon water companies that issue debt to maintain an investment-grade rating from S&P, Moody's or Fitch or any other UK or US "reputable credit-agency".
v. CRAs are increasing research content on their web-sites for which they charge investors. Some participants believe that if they do not subscribe, then they can be at a disadvantage to their peers, and that information relating to a publicly traded bond should be freely available.
vi. IMA members question whether CRAs should have the level of access to non-

public information that they appear to, especially as it leads to their ratings having undue status, particularly among retail investors.

vii. IMA members do not support CESR's idea of an oversight board as such a structure would only serve to enhance the reputation of the CRAs' ratings, rather than diminish them. IMA members however would support the establishment of a trade body for the industry with whom regulators and investors could engage on specific issues.

viii. IMA is concerned that regulators may be closing the stable door after the horse has bolted. It is clear that some CRAs have already reduced their operations in structured finance and it is likely that the market will end up being a fraction of the size it has been in recent years. It would be unfortunate if regulators were to spend a significant amount of time looking at the disclosure for certain products which the market has already decided will not be used any more.

In addition the IMA also pointed out that care needs to be taken over CRAs' disclosures of their rating methodologies in that the more CRAs have to explain their practices the more issuers will model to meet those practices and standards.

Should you have any queries regarding the IMA submission then please do not hesitate to contact me.

Yours sincerely

Liz Rae
Senior Adviser – Investment and Markets

IMMFA
Institutional Money Market Funds Association

25 April 2008

Ms. Kim Allen
IOSCO General Secretariat
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Spain

Dear Ms. Allen

IMMFA comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

The Institutional Money Market Funds Association (IMMFA) are grateful for the opportunity to comment on the consultation report on the role of credit rating agencies (CRAs) in structured finance markets.

IMMFA is the trade association representing the promoters of triple-A rated money market funds[1] and covers nearly all of the major promoters of this type of fund outside the US. Money market funds are brought primarily by institutions to manage their liquidity positions and not for 'total-return' investment purposes. They are used as an alternative to wholesale money market deposits by a wide range of investor types as they offer a practical means of consolidating and outsourcing short-term investment of cash. Total assets in IMMFA members' funds as at March 2008 were in excess of €390 billion. You may obtain more information on triple-A rated money market funds from our website, www.immfa.org.

Our members operate triple-A rated money market funds. Given the requirements imposed in order to maintain a triple-A rating, our members are fully aware of the limitations of a rating and the issues inherent in the CRAs business model. We also recognise the need to conduct independent credit analysis, rather than placing reliance upon the opinion provided by the CRAs.

However, over recent months other investors have placed great reliance upon the ratings of the CRAs. Further, these ratings are now enshrined within the prudential framework of financial regulators across the globe following the implementation of the Basel II requirements, making the return of confidence and integrity to this sector of utmost importance. Inherent within the Basel II framework is reliance placed upon the rating of an

[1] References in this letter to money market funds relates to those funds which comply with the CESR guidance on eligible assets for investments by UCITS, specifically the second bullet point of section 4(2). These funds are also known as '422 funds'.

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external credit assessment institution (ECAI) in the calculation of the capital resources requirement for a financial institution.

If this regime is to prove successful in adjusting capital resources to reflect the risks inherent within an institution, there is pressing need to ensure the CRAs can offer a robust rating which is without question. The implications of the current reviews of the CRAs are therefore wider than just structured finance, making is a necessity for a return of confidence and integrity to this sector. Failure of the CRAs to provide a rating which is robust will have significant implications, not least for the Basel II regime.

We are supportive of the best intentions of the CRAs to comply with the IOSCO Code, and supportive of the reviews which international bodies are undertaking of the role of CRAs within the structured finance markets. To this end, we have recently responded to the consultation paper issued by the Committee of European Securities Regulators (CESR) on CRAs. CESR, pointedly, asked whether respondents considered that the current self regulatory regime should continue, or whether more formal regulation should be introduced.

We consider that the current issues with CRAs, which have been identified in the consultation report, are an indication that the current regime has failed to prevent the crystallisation of risk within the CRAs.

The continuation of the current 'comply or explain' regime is not therefore sufficiently robust to provide the return of confidence in the ratings of the CRAs. The consultation report correctly notes the dominance of the CRA market by three main participants. The current regime requires the CRAs to submit an annual report documenting compliance with the Code, or reasons for any non-compliance. A synopsis of these returns is then made publicly available. The three main participants continue to dominate the market despite not complying with all areas of the Code and this information being publicly available. To expand the current Code but with no requirement to comply is not sufficiently robust to provide market participants with reassurances that minimum standards are actually being adhered with.

There is at present no incentive for the main CRAs to comply with the IOSCO Code. Their dominance of the market has been achieved without full compliance with the Code, and despite this information being available to the public. The consultation report also identifies the current barriers to entry to the market, restricting competition, and increasing the reliance placed upon a small number of key participants.

Any amendments which are made to the current regime must therefore be of a sufficiently fundamental nature to ensure there is an incentive to comply. This would be achieved through some form of regulation or monitoring of the CRAs.

The consultation report raises a number of points where we consider regulation would prove beneficial:

- the need to ensure reliance by the CRAs was only placed on information which is of sufficient quality to support a credible rating;

- the publication of transparent information enabling comparison;

- the segregation of duties relating to the initial rating allocation and subsequent monitoring; and

- the implementation of sufficient controls to minimize the likelihood of conflicts of interest arising.

We do not however advocate that regulation of all activities of a CRA should be introduced. A regulatory framework governing all the activities of a CRA would not provide sufficient flexibility to allow the CRAs to reflect market developments and innovation. A consequence of this lack of flexibility could be a stifling of innovation. This is neither warranted nor desired.

Regulation should only therefore operate to control the conduct of business of the CRAs. Conduct of business regulation would ensure that all CRAs complied with minimum standards, would ensure the market and investors were provided with sufficient information through obligatory transparency requirements, and would manage any conflicts of interest and prevent such having an adverse impact on the ratings assigned.

The introduction of this form of regulation would also provide the market, investors and legislators with sufficient reassurances that these minimum standards were being complied with. This would assist with the return of integrity to the CRAs, and would enable continued usage of the ratings in the assessment of credit risk.

Finally, the consultation report questions whether a separate rating symbol should be utilised within structured finance. We would highlight the fact that within the rating of money market funds, a separate element to the rating is included to give an indication of the opinion of the CRA with regard to the volatility risk inherent within the fund. These ratings have therefore already set a precedent in utilising different classifications, and we would suggest that it may be prudent to extend this practice to structured finance products.

We would welcome the opportunity to discuss these matters with you in more detail.

Yours sincerely

Nathan Douglas.

Nathan Douglas
IMMFA Secretariat

JCR

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April 25, 2008

Ms Kim Allen
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Comments on the IOSCO
Technical Committee Consultation Report on Credit Rating Agencies

Dear Ms Allen,

We are pleased to submit for the Technical Committee's consideration our comment on the Code of Conduct Fundamentals for Credit Rating Agencies as set forth in Annex A to the Technical Committee's March 2008 Consultation Report. We hope the Committee will find our comment useful.

Respectfully submitted,

Takefumi Emori /s/
Managing Director

Comments

1. *We propose that the words 'initial ratings' be dropped from the last sentence of* ***section 1.9****, for the following reasons: It is a foregone conclusion that changes in criteria and assumptions must be taken into account when reviewing past initial ratings. Thus, the words 'initial ratings' in this sentence are superfluous and could mislead one to believe that this section requires changes in criteria and assumptions to be applied retroactively to all past initial ratings.*

2. *To clarify the intention underlying* ***paragraph (1.14-1)****, we recommend that the paragraph should be replaced with the following: A CRA's analysts should restrict themselves to playing passive roles when discussing the design of a structured finance product that CRA rates. For example, objectively stating facts which the analyst knows on the subject as a professional is an acceptable conduct.*

3. *We are concerned that the disclosure described in* ***paragraph (2.8c)*** *may result in a breach of the confidentiality of the issuer's proprietary information. As an alternative, therefore, we recommend that the scope of disclosure be limited to the number of break-up transactions without disclosing the names of originators/issuers, who requested a CRA to evaluate structured finance products.*

4. *To make* ***paragraph (2.17)*** *more practical, we recommend that the paragraph be replaced with the following: The CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated in their responsibility, or a financial firm in their responsibility, with which the CRA has significant dealings, at present and in the past at the CRA.*

5. *Because a CRA rates structured finance products by referring to various factors other than its loss and cash-flow analysis, we recommend that the reference to "loss and cash-flow analysis" in* ***paragraph (3.5a)*** *be deleted. Investors are informed of the basis for a rating by reference to qualitative and quantitative factors, and the most relevant information to a particular product varies from one case to another. CRAs should keep the flexibility of choosing what to disclose to investors/subscribers, as appropriate.*

6. *We expect IOSCO to take an initiative to achieve the goal described in* ***paragraph (3.8)****.*

(end)

Olivier Raingeard[1]

25 April 2008

Ms Kim Allen
IOSCO General Secretariat
Oquendo 12
28006 Madrid
Spain

COMMENTS ON THE IOSCO TECHNICAL COMMITTEE CONSULTATION REPORT ON CREDIT RATING AGENCIES

I would like to thank the Chairmen's Task Force of the Technical Committee of the International Organization of Securities Commissions for having given the opportunity to participate to this consultation. I look forward to continuing dialogue with the Task Force and I am willing to answer[2] any questions or queries you may have regarding this comment.

[1] Economist, Ph.D. (on "The efficiency of rating and regulation")
[2] E-mail address : olivier.raingeard@gmail.com

Summary & main conclusions

- Current issues - CRA transparency and market perceptions, independence/avoidance of conflicts of interest, competition - are broadly similar to those raised in 2002, as the main concerns related to the rating system have not been addressed/resolved (see pages 3-5).

- Regulatory authorities have contributed to the lack of competition because of the absence of guarantee for the conditions for competition, i.e. transparency and free access to the market, the lack of transparency and accuracy of the NRSRO qualification and the use of rating for regulatory purposes (see pages 6-8).

- Currently, the regulatory authorities do not seem to adopt the same approach: American and European views seem quite different for several reasons; the recognition processes also appear to be different (see pages 9-11).

- Current recognition processes are not efficient, generating adverse effects on the rating industry as they gave the illusion of equivalence between rating agencies (see pages 11-14).

- If regulatory authorities want to keep on using rating for regulatory purposes (see page 15), they have to improve significantly the recognition processes:
    - the latter should be based mainly on the notions of reliability and credibility (see pages 16-17);
    - an oversight of the rating industry should be performed in order to prevent the development of ancillary services and practices that could create/increase potential conflicts of interest without monitoring. In other words, rather than raising problems once they occur, it could be more efficient to monitor/supervise their development (see pages 18-20).

- Last, I strongly recommend regulatory authorities to join their efforts to deal with those issues - and others - in order to avoid generating adverse effects on the rating industry.

Introduction

In 2002, the regulatory process of the rating industry was reinitiated[3], after some corporate failures, with the analysis of the role of rating agencies in the financial markets. Three actions took place:

- because of investors which wanted more transparency from rating agencies, some like Moody's and Standard & Poor's carried out surveys [*e.g.* Moody's (2002a, 2002b) and Standard & Poor's (2002)];
- issuers and investors called for more transparency from rating agencies and for regulatory oversight [*e.g.* the AFP survey (2002)];
- regulatory authorities that have/want to regulate rating agencies because of political pressures/mandates and public concerns.

Transparency, market perception, reliability, independence, conflicts of interest, competition were the main themes analysed in 2002. The criticisms levelled at the rating industry mainly concerned the "Main Three", i.e. Standard & Poor's, Moody's and Fitch. For instance, the hearings conducted by the US authorities in 2002[4] and the motivations of Katiforis (2004) mainly focused on their role[5]; the working document on rating agencies of the European Parliament (2003) mainly dealt with Standard & Poor's, Moody's and Fitch, through the presentation of the historical evolution, the methodology and ratings definition, and the critical remarks…

Despite numerous auditions, reports, advices, code of conduct… the regulatory issues raise in 2008 are broadly the same! A brief analysis of the "possible regulatory issues" pointed out by the current IOSCO's consultation report leads us to this conclusion. Indeed, the latter deals with:

- **CRA transparency and market perceptions**. The fact that CRA "do not publish verifiable and easily comparable performance data regarding their ratings"[6], that "statistics regarding long term default rates do not necessarily provide information

[3] The SEC tried to improve its oversight of rating agencies, through its NRSRO qualification in 1994 and 1997.
[4] See the hearings conducted by the U.S. Senate in 2002: United States Senate, 2002a, "Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Committee on Governmental Affairs United States Senate", Committee on Governmental Affairs, March 2002, One Hundred Seventh Congress, Second Session; United States Senate, 2002b, "Financial Oversight of Enron: the SEC and Private-Sector Watchdogs", Report of the Staff of the Senate Committee on Governmental Affairs, S.Prt. 107-75, October.
[5] *In* European Parliament, 2004, "Report on role and methods of rating agencies", Committee on Economic and Monetary Affairs, A5-0040/2004, January.
[6] As in 2003 when the SEC called for comment on the standardization of rating symbols for example. For further details, see U.S. Securities and Exchange Commission, 2003a, "Concept Release : Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", U.S. Securities and Exchange Commission, June 2003, Release n°33-8236, 34-47972; File n°S7-12-03.

about short term default probabilities"[7], that CRA were to "slow to review, and if necessary, downgrade existing credit rating" and by contrast "that some CRA very quickly downgraded certain structured finance product"[8] were pointed out in 2002. The sole criticism that could be considered as new is that CRA "have been slow to modify either their methodologies or the assumptions used by their methodologies".

- **Independence/avoidance of conflicts of interest**. Once again, the "issuer fee model" used by the main rating agencies is criticised. Actually, it is a concern since they have adopted this business model in the 70's! For which reasons independence is still a concern whereas, broadly, market participants recognise that rating agencies manage this conflict of interest?
- **Competition**. One again, the question of competition is raised[9]. Regulatory authorities are mindful of the reasons explaining the lack of competition - "as the CRA report notes, some observers believe the nature of the CRA "market" may make it difficult for new CRA entrants to succeed"[10] -. But are they aware of their own role and of the potential negative effects they can produce on the rating industry?

Consequently, despite few progresses made by rating agencies, "partly" due to regulation, one should consider that issues related to the rating industry have not been resolved. Moreover it seems doubtful that the current review of the rating industry could improve significantly the situation as the main issues are not necessarily raised. I am using the opportunity of this worldwide consultation to address concerns - emphasized in earlier consultations[11] -, principally related to the two last subjects mentioned above.

Firstly, concerning competition, I am very surprised by the fact that the IOSCO consultation report (2008) notices that "CRA Report noted in 2003 that CRAs were not extensively regulated in most IOSCO jurisdictions and those regulations that did exist are not onerous for new entrants". Has not the SEC regulate the rating market - the main market for the rating industry - with its NRSRO qualification since 1975? From my point view, regulatory

[7] As in 2000-2002 when corporate default rates were higher than its long term average. For more details, see for example Raingeard O., 2003, "Comments of Olivier Raingeard on S7-12-30", Securities and Exchange Commission Concept Release: "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 27.

[8] As in 2002 when issuers believed that "rating upgrades take longer to occur compared to rating downgrades". According to the AFP survey (2002), "most respondents do not believe changes in their company's finances are promptly reflected in the ratings" *in* Association for Financial Professionals, 2002, "Rating Agencies Survey: Accuracy, Timeliness, and Regulation", November.

[9] Market participants called for more competition in the rating industry, as it is shown - for instance - by the AFP Survey (2002) which stated that "[T]reasury and finance professionals support additional competition in the market for credit ratings".

[10] *In* IOSCO, 2008, "The role of credit rating agencies in structured finance markets", Technical Committee of the International Organization of Securities Commission", March.

[11] See Raingeard (2003, 2004, 2005a).

authorities have contributed to this situation because of an inadequate regulation, a lack of guarantee of the conditions for competition and the use of ratings for regulatory purposes. Nowadays, one should wonder if regulation is not generating adverse effects because of the multiplication of recognition processes and the weaknesses of the latter.

Secondly, I do not share the view that the "issuer fee model" constitutes a major concern even though this potential conflict of interest could be more "acute" in structured finance. Besides most market participants seem to recognize that rating agencies addressed this potential conflict of interest: "[T]he practice of issuers paying for their own ratings creates the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information (…) The larger rating agencies and a number of other market participants agree that the issuer-fee model creates the potential for a conflict of interest, but believe that the rating agencies historically have demonstrated an ability to effectively manage the potential conflict"[12]. Nonetheless, one should consider that few rating practices and the development of ancillary services create/exacerbate potential conflicts of interest and contribute to have doubts about the independence of rating agencies.

Last, I would like to address credit rating agencies transparency and market perception. Once again, the question of the reliability and credibility of rating agencies is pointed out as in 2002 when the latter where particularly criticised, especially in the Enron case: "The market is, by-and-large, unharmed by the poor quality of ratings, because market participants are sophisticated enough to ignore the ratings. The real problem with the declining quality of credit ratings is that regulators are using credit ratings (…) To the extent that ratings are of poor quality, the quality of these myriad regulatory schemes are compromised. The quality of U.S financial regulation is being compromised by its pervasive reliance on credit ratings."[13]

A- Competition

The question of competition in the rating industry has to be analysed through a few theoretical conditions: homogeneity, transparency and free access to the market. This analysis leads us to conclude that regulatory authorities have contributed to this lack of competition and that the latter have to wonder if they do not generate adverse effects.

[12] *In* Securities and Exchange Commission (2003a), see footnote 6.
[13] *In* U.S. Senate (2002a), see footnote 4.

1-An analysis of the theoretical conditions for the rating market

Is there any homogeneity on the rating market? The rating is not necessarily "a homogeneous product". An analysis of rating agencies' reliability through split ratings, rating's criteria and the evolution of historical ratings before the default event demonstrates that differences of reliability between the "Main Three" exist[14]. By considering the impact of their ratings on credit spreads, it appears that differences of rating agencies' credibility can be observed [*e.g.* Cantor, Packer and Cole (1997), Raingeard (2005b) find that Standard & Poor's and Moody's have the same credibility; contrary to Jewell and Livingston (1999), it seems that Fitch has a specific credibility (Raingeard, 2005b)].

Is there any transparency on the rating market? For the "Main Three", issuers pay for corporate ratings and the price is a percentage of the issue's amount [see White (2001)]. Nonetheless, if rating schemes are disclosed, rating's prices are not necessarily transparent, *e.g.* as far as I know the NRSROs do not publicly disclose them. Besides the SEC (2007) believes that its final rule on the oversight of credit rating agencies registered as Nationally Recognized Statistical Rating Organizations "should elicit more information about fees so that the information will be disclosed to users of credit ratings. This will improve price transparency, which may lead to greater competition."[15]

Is the market free to access? Natural barriers to entry linked to credibility, reliability and time and resources necessary to set them up exist. Nevertheless, one could consider that there are exogenous barriers related to the role of regulatory authorities. In other words, the latter have contributed to the oligopoly on the rating market.

2-Regulatory authorities as an explanatory variable of the lack of competition

If I broadly agree with the natural barriers to entry mentioned by IOSCO, from my point of view the history of the rating market explains its current structure. Indeed, one should consider that the regulatory authorities have contributed to this result because of the lack of transparency/accuracy of the NRSRO status - even though the SEC recognised some rating agencies -, the absence of guarantees for competition, and the use of rating as a regulatory tool.

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[14] For further details, see Raingeard (2003, 2005b) demonstrating that differences of reliability between rating agencies exist.

[15] *In* Securities and Exchange Commission, 2007, "Final Rule: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations", Release n° 34-55857; File n° S7-04-07, June 5.

The lack of transparency/accuracy of the NRSRO status has probably dissuaded potential competitors. Indeed, the SEC did not disclose applications for NRSRO recognition and did not define a planning for its decision. For example, Lace Financial Corporation (2002) criticised the NRSRO status: "I would hope that this time the SEC would process our appeal for NRSRO status on a more timely process (the last application took eight years). It would also be helpful if the Division of Market Regulation could be more forthright with us and tell us in writing what part of the SEC criteria we do not meet."[16] Moreover, even though the SEC (1997) stated that "the single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings"[17], several criteria were not necessarily objective or accurate[18].

The conditions for competition were not "secured". The fact that Moody's and Standard & Poor's rate, in the United States, all public corporate debt issues has probably hindered the development of competitors. As an example, Standard & Poor's admits that it rates "99,2% of the debt obligations and preferred stock issues publicly traded in the United States"[19]. Therefore, in the United States, corporate issuers have *de facto* two ratings, with or without request, contributing to hinder rating agencies' development. This has probably leaded Fitch to develop its activities by acquisitions of some NRSROs[20], but its market share remains thin.
Consequently, the SEC - despite some recognitions - has not necessarily secured the conditions for competition as it does not monitor this systematic rating policy. Nevertheless, the SEC has not necessarily the power to take action as Standard & Poor's and Moody's policies seem to rely, in the United States, on the First Amendment protection - rating is an opinion - and the so-called "journalist's privilege". Furthermore, it seems that rating agencies have to adopt such policy in order to be considered as a journalist. Indeed, in the case In RE Fitch, the Court finds that "unlike a business news paper or magazine, which would cover any transactions deemed newsworthy, Fitch only "covers" its own clients. We believe this practice weighs against treating Fitch like a journalist."[21] Consequently, it seems that, from a legal point of view, there is not a level playing field between rating agencies.

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[16] *In* Lace Financial Corporation's Letter to the SEC, 2002, "Appeal for Lace Financial Corporation to receive Nationally Recognized Statistical Rating Organization status", September 26.
[17] *In* Securities and Exchange Commission, 1997, "Capital Requirements for Brokers or Dealers Under the Securities and Exchange Act of 1934", "Proposed Rule", Release n° 34-39457; File n° S7-33-97, December 17.
[18] See, for example, Rating and Investment Information's comments on the SEC's Concept Release (2003). Rating and Investment Information, 2003, "Comments of Rating and Investment Information on S7-12-34", Securities and Exchange Commission Concept Release: "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws", July 28.
[19] *In* Standard & Poor's, 2003, "Corporate Rating Criteria".
[20] Ficth Ratings is the result of several merger/acquisition with other NRSROs.
[21] *In* United States Court of Appeals for the Second Circuit, 2003, Docket Nos 03-7062, 03-7076, May 21.

The use of ratings for regulatory purpose has probably contributed to this result. Indeed, regulatory authorities, by recognising/qualifying rating agencies and using their ratings for regulatory purposes, encourage issuers to request a "recognised/qualified rating" because of credibility recognition, notoriety effect, and regulatory concerns[22]. Besides, this influence is well-described in the current IOSCO consultation (2008): "to the extent that regulatory recognition is based on reliance by market, and market reliance is influenced by regulatory recognition, the cycle of discrimination is perpetual."

Furthermore, it seems that regulations based on ratings could lead to the development of "multiple ratings" and, consequently, to "rating shopping" practices. Based on similar research to find explanatory factors of third rating that Cantor and Packer (1995b, 1997) performed[23], I confirm some of their results and I find that firms seem to look for it in order to meet regulatory requirements. Consequently, the nature of the rating could have changed: issuers could look for ratings, not to reduce informational asymmetry, but in order to be "eligible"[24].

3- Do regulatory authorities still generate adverse effects on the rating industry?

For those reasons, I consider that regulatory authorities, and more particularly the SEC, have generated adverse effects on the rating industry. This point of view is not necessarily shared. The SEC (2003b) notices that "most were of the view that the regulatory use of the NRSRO concept, in and of itself, did not act as a substantial barrier to entry (…) One concern widely expressed by hearing participants, however, involved the relative lack of transparency of the existing NRSRO recognition process conducted by Commission staff."[25]

Moreover, one could claim that the systematic rating policy of Standard & Poor's and Moody's in the United States does not raise problems from an European point of view or other regions in the world. Nonetheless, it contributes to explaining the rating market's structure - *e.g.* Fitch has developed its activities by acquisitions; revenues generated in the American market (have) allow(ed) NRSROs to have resources in order to cover (by acquisitions or not) the growing European rating market; European issuers operating in the

[22] U.S. authorities use ratings in their regulations in order to "secure their financial system". For further details, see for example: Cantor and Packer, 1995a, "The Credit Rating Industry", Federal Reserve Bank of New York, Research Paper No.9527, December; Securities and Exchange Commission (1997), see footnote n°17.
[23] Cantor R., Packer F., 1995b, "Multiple Ratings and Credit Standards: Differences of Opinion in the Credit Rating Industry", Federal Reserve Bank of New York, Research Paper No.9527, December. Cantor R., Packer F., 1997, "Differences of Opinion and Selection Bias in the Credit Rating Industry", Journal of Banking and Finance, 21.
[24] Issuers could look for "multiple ratings" in order to reduce the costs of their debts too. For more details, see Raingeard (2005b).
[25] *In* U.S. Securities and Exchange Commission, 2003b, "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market", U.S. Securities and Exchange Commission, January 2003.

United States (have to) look for a rating from a NRSRO… Furthermore, what would be the consequences of a systematic rating policy (or a significant increase of unsolicited ratings) from Fitch, in the United States, for newly recognised "global rating agencies"? What would be the consequences for the rating industry if dominant rating agencies develop this policy for growing market?

One could also claim that the SEC has improved its recognition process in 2007. Nevertheless, nowadays, the multiplication of regulations raises concerns from different point of view. First of all, regulatory authorities do not adopt the same approach. Secondly, on should wonder if the recognition processes defined by regulatory authorities are efficient. Do not they give the illusion of homogeneity between rating agencies through their recognition? More broadly, do not they give the illusion to investors that ratings are a "perfect" assessment of credit risk?

Different regulatory authorities, different approaches?

It seems that American and European views are quite different for several reasons. Furthermore, the new recognition process of the SEC (2007) is quite different than the guidelines defined by the Committee of European Banking Supervisors (CEBS) in 2006 and applied by European securities regulators[26].

As stated earlier, rating agencies' policy seems to rely, in the United States, on the First Amendment - rating is an opinion - and the so-called "journalist's privilege". According to the European Parliament report (2004) and the "Call to CESR for Technical Advice"[27] (2004), it seems that European authorities have an other view. For instance, Katiforis states that "this analogy [rating agencies "act in a journalist capacity"] does not hold much water from the moment that ratings become part of the regulatory mechanism of financial markets, even against the better judgement of rating agencies."[28] Furthermore, some points of the Technical Advice of the CESR seem to be far from the US point of view. Indeed it seems that European authorities were willing to go towards a strict regulation of this industry. Nevertheless, in 2005, CESR proposed "not to regulate the Credit Rating Agencies industry at an EU level for the time being, and instead proposed that a pragmatic approach should be adopted to keep under review how CRAs would implement the standards set out in the

[26] Committee of European Banking Supervisors, 2006, "Guidelines on the recognition of External Credit Assessment Institutions, January.

[27] Committee of European Securities Regulators, 2004, "CESR's technical advice to the European Commission on possible measures concerning credit rating agencies", November.

[28] *In* European Parliament (2004), see footnote 5.

IOSCO Code of Conduct."[29] The subject is not closed as the Commission have expanded its request to the CESR task force "to include an investigation whether the recent developments within structured finance would cause CESR to change its view whether to regulate CRAs or not"[30]. I will be very curious to see the development if CESR reaches, this time, a different conclusion. Furthermore, it is doubtful to consider that there are no few political concerns as Katiforis notices "that the predominantly American character of the agencies and of their supervisors (SEC, US Congress) creates a vast de facto imbalance towards the American side."[31] Such outcome could have a negative effect on the rating industry. Besides, this was already a concern in 1994! Responding to the SEC concept release, Moody's (1994) claimed that "[G]overnments may have compelling and legitimate public policy interests that appear to transcend the principle of rating agency independence. These other policy interests make it difficult to imagine an "official" rating agency's downgrading a government agency, a major bank, or a foreign government. One may easily imagine that such actions might from time to time be brought to the attention of a regulator who might in turn feel obliged to ensure that "appropriate" procedures had been followed and "reasonable" standards applied. There would be little need for overt interference in rating decisions; regulatory inquiry alone would have a chilling effect. The power to regulate is inevitably the power to influence."[32]

The second concern is linked to the current recognition processes adopted by the SEC (2007) and European securities regulators, using guidelines of the CEBS (2006) in order to recognise rating agencies whose rating can be used for regulatory purposes, i.e. the recognition of External Credit Assessment Institution defined by Basel II.

On the one hand, until its new rule in 2007, the SEC seemed to primarily rely on the reliability and credibility of rating agencies. Indeed, the SEC (1997) claimed that the "single most important criterion is that the rating organization is nationally recognized, which means the rating organization is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings"[33]. Its new rule drops the concepts of reliability and credibility of rating. Indeed, the Commission employs the term "performance" and requires "that an application for registration as an NRSRO contain credit rating

[29] *In* Committee of European Securities Regulators, 2008, "The role of credit rating agencies in structured finance", Consultation Paper, February.
[30] *In* CESR (2008), see footnote 29.
[31] *In* European Parliament (2004). See footnote 5.
[32] *In* Moody's Investors Services, 1994, "Response to Concept Release Regarding Nationally Recognized Statistical Rating Organizations", U.S. Securities and Exchange Commission, 5 December 1994, Release n°33-7085; 34-34616; File n°S7-23-94.
[33] *In* Securities and Exchange Commission (1997), see footnote 17.

performance measurement statistics"[34]. The Commission only looks for reliability in order to compare performance between NRSROs[35].
On the other hand, the "Guidelines on the recognition of External Credit Assessment Institutions" defined by the CEBS (2006) affirm that the "recognition criteria is to identify ECAI that produce external credit assessments of sufficiently high quality, consistency and robustness to be used by institutions for regulatory capital purposes under the Standardized approach"[36]. The Committee uses the terms robust - "competent authority will take into consideration the ability of the ECAI to produce robust credit assessments"[37] -, accurate -"the demonstration should (…) be supported by statistical evidence that the methodology has produced accurate credit assessments in the past"[38] -…

Are the recognition processes efficient?

I would like to focus on the guidelines of the CEBS (2006), whose goal is to define a common approach to the recognition of eligible criteria. The proposition of the CEBS covers the recognition process, the implementation of the CRD recognition criteria and the criteria for "mapping" external credits assessments to the risk weights. From my point of view, the guidelines have the following weaknesses: the criteria of recognition are not necessarily accurate; the criteria of mapping are not sufficiently developed. Consequently, regulatory authorities can give the illusion that rating agencies are equivalent.

The technical criteria of recognition are those of objectivity - "competent authorities shall verify that the methodology for assigning credit assessments is rigorous, systematic, continuous, and subject to validation based on historical experience"[39] - ; independence - "competent authorities shall verify that the methodology is free from external political influences or constraints, and from economic pressures that may influence the credit assessment"[40] - ; on-going review ; transparency and disclosure. The individual credit assessments are based on credibility and market acceptance - "competent authorities shall verify that ECAI's individual credit assessments are recognised in the market as credible and

[34] *In* Securities and Exchange Commission (2007), see footnote 15.
[35] "The Commission intends to continue to consider this issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of performance between NRSROs." *In* Securities and Exchange Commission (2007), see footnote 15.
[36] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[37] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[38] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[39] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[40] *In* Committee of European Banking Supervisors (2006), see footnote 26.

reliable by the user of such credit assessment"[41] - and on transparency and disclosure of individual credit assessments. This methodology raises two main concerns: who recognise the reliability and credibility of the ECAI? The market, the competent authorities, or both? Are the elements of credibility and market acceptance efficient?

Indeed, on the one hand, the paragraph 88 states that "competent authorities should concentrate on assessing whether the credit assessment processes adopted by an ECAI produce credit assessments that embody a sufficient level of consistency and discrimination to provide the basis for capital requirements…"[42]. In order to do so, the CEBS claims that the assessment should focus on the "quantitative evidence of the discriminatory power of the ECAI's credit assessment methodology, using statistical techniques such as default studies and transition matrices to demonstrate the robustness and predictive power of credit assessments over time and across different asset classes"[43]. Consequently, one could consider that competent authorities assess the reliability of credit ratings. Nonetheless, the criteria seem quite vague or inaccurate[44]. On the other hand, competent authorities in order to assess "credibility and market acceptance" have to tale into account the following elements: "market share of the ECAI; revenues generated by the ECAI, and more in general financial resources of the ECAI; whether there is any pricing on the basis of the rating, in case at least two banks use the ECAI's individual credit assessment for bon issuing and/or assessing credit risk"[45]. This approach raises several concerns:

- firstly, I do not share the view that the market share of the ECAI constitutes a mean to assess its credibility. Indeed, how competent authorities estimate this market share for ECAI issuing "public good" and "private good"[46]?
- secondly, revenues generated by the ECAI and general financial resources are quite similar with the criteria of market share and independence;
- thirdly, as exogenous and endogenous barriers seem numerous (see above), it seems difficult to take into consideration "evidence of widespread use in the market" to assess the credibility and reliability of ECAIs, particularly for small or new rating agencies.

Concerning the mapping approach, the technique is insufficient and should have adverse effects on the rating industry. Indeed, even though guidelines advocate that "absolute

[41] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[42] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[43] *In* Committee of European Banking Supervisors (2006), paragraph 89. See footnote 26.
[44] This point is developed latter, by examining the mapping methodology.
[45] *In* Committee of European Banking Supervisors (2006), paragraph 89. See footnote 26.
[46] It means rating agencies having an "issuer fee model" as opposed to those having a "subscriber fee model".

accuracy in the mapping process is likely to be neither possible nor necessary"[47], the approach suffers from weaknesses. Guidelines claim that the "use of three-year Cumulative Default Rates (CDRs), evaluated over the longer term and on an on-going basis, is considered to provide an appropriate measure of the predictive power of credit assessments in relation to creditworthiness."[48] Qualitative factors must be taken into consideration for ECAI that "have compiled only a short record of default data"[49].

One should consider that this approach is quite reductive as ECAI could have sample (number of issuers rated) that generates biased results[50]; furthermore, the sole comparison of default rates is not sufficient to compare rating performance and should lead to inappropriate mapping. For example, the French supervisory authority - the Commission bancaire - has listed the following ECAIs: Banque de France, Coface, Dominion Bond Rating Services (DBRS), Fitch Ratings (Fitch), Japan Credit Rating Agency (JCR), Moody's Investors (Moody's), Standard & Poor's (S&P's). The mapping for the last five rating agencies is defined as follow:

External Credit Rating Assessment Institutions and Mapping in France for claims on corporate

ECA risk scores	Risk weight	**Ratings of ECAIs**				
		DBRS	**Fitch**	**S&P's**	**Moody's**	**JCR**
1	20%	AAA/AAL	AAA/AA-	AAA/AA-	Aaa/Aa3	AAA/AA-
2	50%	AH/AL	A+/A-	A+/A-	A1/A3	A+/A-
3	100%	BBBH/BBBL	BBB+/BBB-	BBB+/BBB-	Baa1/Baa3	BBB+/BBB-
4	100%	BBH/BBL	BB+/BB-	BB+/BB-	Ba1/Ba3	BB+/BB-
5	150%	BH/BL	B+/B-	B+/B-	B1//B3	B+/B-
6	150%	CCCH	CCC+	CCC+	Caa1	CCC+

Consequently, investors can consider that, due to this mapping approach, those rating agencies give "similar" credit assessments. But is there any equivalence among them? This concern has been already raised by some rating agencies since 1994! For example, Moody's (1994) claims that "the SEC appears to have created in the capital markets merely the *illusion* of equivalence among the various agencies, their ratings and their rating standards. This illusion, Moody's believes, creates the opportunity for rating shopping (…). In addition, because of the manner in which the SEC uses NRSRO ratings in its regulations, investors may be led - fallaciously - to conclude that all NRSRO ratings of a certain level express opinions denoting equivalent levels of risk"[51]. Numerous researches demonstrate that differences

[47] *In* Committee of European Banking Supervisors (2006), see footnote 26.
[48] *In* Committee of European Banking Supervisors (2006), paragraph 126. See footnote 26.
[49] "Qualitative factors would be particularly important in making that demonstration" *in* Committee of European Banking Supervisors (2006), paragraph 126. See footnote 26.
[50] See for example the first historical annual study of Fitch released in 2001 who gave biased results, especially for the speculative grade sample.
[51] *In* Moody's Investors Services (1994), see footnote 32.

between rating agencies exist. For instance[52], Packer and Reynolds (1997) find significant differences between the ratings of Standard & Poor's and Moody's and those of Japanese rating agencies, i.e. Rating and Investment Information and Japan Credit Rating: "Japanese investors are unlikely to assume that the Japanese agencies' particular grade ratings correspond to the same absolute level of default risk as the ratings of Moody's and Standard & Poor's. More likely, Japanese investors will consider the information provided by Japanese agency ratings about the rank ordering of default risk."[53] Based on a sample constructed in 2003, Raingeard (2005b) finds similar results[54]. Does it mean that Japanese agencies' rating is not reliable information? Not necessarily as Packer and Reynolds (1997) and Packer (1999) affirm that credit spreads are correlated to R&I ratings.

4-Propositions to improve the conditions for competition

Even though it seems doubtful that a new global rating agency can emerge, regulatory authorities can improve transparency, the access to the market and the recognition processes.

Transparency

In order to increase transparency, rating agencies could improve the documentation of their rating scheme, *e.g.* what are the determinants of the rating's price? To what extent rating's prices could be subject to negotiation? Does the credit rating agency use an annual subscription fee that can be used as a credit against future debt issuance?… Possibly, one could imagine a supervisory authority to which issuers could turn in order to denounce unfair practices[55].

Free access to market

The conditions for competition must be ensured. For example, on the one hand, it could be useful to monitor the development of unsolicited ratings in order to prevent rating agencies to use it so as to reduce competition. On the other hand unsolicited ratings could help new

[52] See also Beattie and Searle (1992), Cantor and Packer, (1995a, 1995b, 1997), Jewell and Livingston (1999), Raingeard (2003, 2005b).

[53] *In* Packer F., Reynolds E., 1997, "The Samurai Bond Market", Federal Reserve Bank, Current Issues in Economics and Finance, June, Vol 3, n°8.

[54] Moody's and Standard & Poor's assign ratings that are inferiors to those of Rating & Investment Information and Japan Credit Rating in 90% of the cases.

[55] Such authority could deal with unfair practices linked to credit rating agencies influence, unwillingly cooperation or payment for a rating.

entrants to gain market share/reputation… Consequently, in order to conciliate these two approaches, unsolicited ratings could be regulated by a simple set of rules[56]:

- rating agencies broadly explain that unsolicited ratings are requested by investors. In order to legitimate this action, formalised requests from a significant threshold of investors would be required for the "Main Three";
- as stated by rating agencies, issuers are an important source of input. Unsolicited ratings, although reliable, have not necessarily the same value as solicited ones. Consequently, unsolicited ratings should be clearly identified through as such (with a "signal" pi for public information for example)[57];
- unsolicited ratings should not be used for regulatory purposes.

Regulatory recognition

This area is a difficult task as it raises few questions: is it efficient to use rating for regulatory purposes? If yes, what kind of recognition process could be more efficient than those currently applied?

Is it efficient to use rating for regulatory purposes? I have no definitive answer to this question. One the hand, I guess that the use of ratings for regulatory purposes could be useful as rating reduces informational asymmetry, contributes to improve market efficiency… as far as it is reliable and credible. On the other hand, the use of rating for regulatory purposes can give the illusion to investors that rating is a "perfect" assessment of credit risk.

Besides, the SEC (2003a) called for comment on the alternatives to the NRSRO designation, trying to "identify alternatives capable of achieving the regulatory objectives currently served by use of the NRSRO designation in certain Commission rules"[58]. "Most of the 46 commenters responding to the 2003 Concept Release supported retention of the NRSRO concept. They generally represented that, among other things, eliminating the NRSRO concept would be disruptive to the capital markets, and would be costly and complicated to replace. Only four commenters supported elimination of the concept, and there was limited discussion of regulatory alternatives."[59] As regulatory authorities seem to keep on using ratings in regulation - if not, the rating industry could be based only on a code of conduct

[56] Nevertheless, it is doubtful that market participants, and more particularly rating agencies, share this point of view. In a worldwide perspective, this set of rules could have difficulties in overcoming the First Amendment in the United States.

[57] A time period - issuer could not request a rating and rating agency could not assign solicited rating - could be imposed after an unsolicited rating. This set of rules could have difficulties to overcome the First Amendment in the United States.

[58] *In* Securities and Exchange Commission (2003a), see footnote 6.

[59] *In* Securities and Exchange Commission, 2005, "Proposed Rule: definition of Nationally Recognized Statistical Rating Organization"; Release n°33-8570; 34-51572; File n°S7-04-05.

(which may ensure its credibility) and the market could be the sole judge of the rating agencies' performance -, it could be more efficient to consider the following propositions.

What kind of recognition process could be more efficient than those currently applied?

Broadly, rating is a relative measure of credit risk which is relatively stable. Furthermore, the performance of ratings can be estimated from an absolute point of view. In economic sciences, credibility is used to assess central bank policy. Credibility is ensured if central bank has clear goals (role, assignment), has a strategy (tools) and an adequate structure to reach its goals. Consequently, according to those notions, the recognition process should be based on the following methodology.

In order to assess the reliability of rating agencies:

- **an individual analysis of the rating agency's performance should be performed** by studying the *relative performance of the rating agencies* [the relation rating-default rate (annual and cumulative) so as to "appreciate" agency's rating scale[60], the agency's "power curve" in order to appreciate how the agency distinguishes defaulters and non-defaulters, the agency's transition matrices in order to "appreciate" rating's scale and stability]; *the stability of rating* (the examination of rating actions : the frequency of rating's upgrades and downgrades ; rating changes : the rating variation and rating reversals); *an analysis of the rating's absolute performance* (it would consist in an analysis of annual default rates for investment and speculative grade issuers relative to their historical mean and determinants[61], an analysis of average rating prior to default in order to appreciate the agency's capacity to anticipate default, possibly a comparison between rating and absolute measures of credit risk);
- **a comparison of rating agencies' performance should be performed**, based on a comparison of *rating agencies' relative performance*, considering their "power curve" ; a comparison of *rating agencies' absolute performance*, considering their average rating prior default ; a comparison of *stability of ratings* based on the three measures quoted ; a comparison of *rating differences*.

Credibility's criteria should mainly be based on the disclosure of *rating's objectives, rating agency's strategy and rating's methodologies*; and *the organisational structure* that is to guarantee rating agency's independence, minimise and/or manage (potential) conflicts of

[60] "Mortality rate" could also be analysed [see Altman (1989) for a definition].
[61] According Jónsson and Fridson (1996), Jónsson, Fridson and Zhong (1996), Helwege and Kleiman (1996), Fridson, Garman and Wu (1997), Raingeard (2005b), explanatory variables of speculative grade default rates are

interest, protect confidential information[62]. An analysis of the effective credibility based on market participants' opinion could be useful too.

This methodology would allow the qualification of reliable and credible credit rating agencies based - as far as possible[63] - on objective criteria[64], thus this would minimise entry barriers. Nonetheless, this may not be sufficient and regulatory authorities should:

- improve the transparency of the recognition process[65] and further use of ratings in regulation should try to minimize multiple ratings' incentives, contrary to the potential impact the "Standardised Approach" - proposed by Basel II - may have[66];
- try to guarantee the conditions for competition by increasing transparency (as stated before);
- oversee the credit rating industry in order to prevent anti-competitive or unfair practices, the development of potential conflicts of interest inadequately addressed[67].

One should wonder if regulatory authorities have the means to deal with rating recognition and oversight of the rating industry. One should wonder too if it could be more efficient/if it is possible to imagine a worldwide regulation/supervision.

B-Conflicts of interest

At first sight, it is logical to consider the fact that a rating agency paid by the issuer, which wants to "obtain the best grade", constitutes a conflict of interest. Nonetheless, it seems broadly admitted by market participants that credit rating agencies, i.e. the "Main Three", manage this conflict of interest because credibility is probably one of the most important criterion of this industry. Indeed, Cantor and Packer (1995a) claim that "while the current payment structure may appear to encourage agencies to assign higher ratings to satisfy

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the economic and monetary environment, the sample's distribution, the lag between the issue and the default event…

[62] Those criteria are broadly implemented in current recognition and code of conducts.

[63] At least, it will improve the current Guidelines of CEBS (2006).

[64] The different approaches proposed to estimate the credibility and the reliability of credit rating agencies could tend to define an objective qualification, without imposing strict standards that might generate the homogenization in the rating industry.

[65] Rating agency's request should be disclosed; public comments should be solicited; the decision should be taken "in a short time period", should be motivated (on the criteria) and communicated to market participants.

[66] For further details, see Raingeard (2003). For instance, an idea would be to consider the issuer's lowest rating for regulatory purposes.

[67] See the developments related to conflicts of interest and the propositions to increase transparency.

issuers, the agencies also have an overring incentive to maintain a reputation for high quality, accurate ratings. If investors were to lose confidence in an agency's ratings, issuers would no longer believe they could lower their funding costs by obtaining its rating." Covitz and Harrison (2003) find evidences that reputation incentives dominate for Standard & Poor's and Moody's: "[R]ating agencies appear to be relatively responsive to reputation concerns and so protect the interests of investors"[68].

Despite this general acceptance, conflicts of interest are still a concern for market participants and regulatory authorities. It is well-known by market participants and regulatory authorities that, in order to reduce the potential issuer's influence and increase transparency, rating agencies should ensure the independence of people involved in the rating process through policies and procedures; in order to ensure the credibility of the rating's system, direct or indirect capital link with issuer should be prohibited; and the disclosure to regulatory authorities and/or to market participants when issuers exceed a certain percentage of the revenues should be required.

Nonetheless, those improvements will not change substantially this kind of issues. For instance, the fact that "CRA should disclose if it receives 10 percent or more of its annual revenue from a single issuer…" (IOSCO 2008, point 2.8b) is welcome; but it would probably concerned smaller rating agencies that have a more concentrated turnover's structure and it is probably already implemented in practice[69]. Furthermore, it would not resolve entirely the concerns related to potential conflicts of interest because the main issues are not addressed. More precisely, I draw, again, the attention of regulatory authorities about preliminary ratings and the development of ancillary services.

1-Preliminary credit ratings

During previous consultations, I argue that preliminary corporate credit ratings have to be prohibited[70]. After the initial contact between the agency and the issuer and the communication of the appropriate information, few rating agencies (NRSROs and non-NRSROs) provide a preliminary rating, which can be comprised within a range (*e.g.* a preliminary rating A+/A; in certain cases, a probability of realisation is indicated). If the

[68] *In* Covitz D., Harrison P, 2003, "Testing Conflicts of interest of Bond Rating agencies with market anticipation : Evidence that reputation Incentives Dominate", Finance and Economics Discussion Series 2003-68, Board of Governors of the Federal Reserve System.
[69] *e.g.* see the common basis application pack of the CEBS (2006) - "the total number and percentage of revenues from major customers and/or subscribers (*e.g.* customers or subscribers accounting for 5% or more of total revenues)" - and the exhibit 10 of the SEC's final rule (2007) requiring "a list of the 20 largest issuers and subscribers that use the credit rating services provided by the credit rating agency by amount of net revenue…"
[70] See Raingeard (2003, 2004, 2005a).

issuer accepts this preliminary rating, the rating procedure is engaged; otherwise, he can drop the process. Once the rating committee has occurred, the issuer has no longer discretion on the rating.

This practice clearly reinforces the potential issuer's influence and can have adverse effects on the rating industry as:

- the rating agency's credibility would be eroded because the issuer's influence seems important or, at least, rating agencies would not be perceived as independent;
- this policy clearly reinforces "rating shopping" incentives/practices. Paradoxically, an increase of competition could then lead to a deterioration of the quality of the rating's system.

In structured finance, the issues are broadly the same. The fact that the sponsor could "choose not to hire [a] CRA and instead have another CRA rate the security, in which case the sponsor may or may not (depending on the engagement contract) pay the initial CRA a break-up fee"[71] increases potential "rating shopping" practices.

2-Ancillary services

Needless to say that the first task of regulatory authorities will be to identify the different advisory/ancillary services proposed by rating agencies and their affiliates and not only to charge credit rating agencies to disclose "what it considers, and does not consider, to be an ancillary business and why"[72]. Recent events concerning the financial industry have shown that conflicts of interest can be difficult to manage. Consequently, in order to ensure that the rating industry keeps its credibility, regulatory authorities and market participants will have to deal with these points.

Concerning structured finance, few practices raise concerns. Is it "efficient" (for the rating industry) that rating analyst makes proposals regarding the design of structured finance products? Is it efficient that rating agencies develop services related to price transactions on the secondary market[73]? Concerning corporate credit rating and rating assessment services, if it seems coherent that issuers wonder what the rating consequences of an action (merger, acquisition...) should be, a simple set of rules could be defined in order to manage this conflict of interest.

[71] *In* IOSCO (2008), see footnote 10.
[72] *In* IOSCO (2008), point 2.5, see footnote 10.
[73] See Aguesse P., 2007, "La notation est-elle une réponse efficace aux défis du marché des financements structurés », Autorité des Marchés Financiers, Direction de la Régulation et des Affaires Internationales, Risques et tendances n°2, mars.

3- Propositions to increase independence

Regulatory authorities should deal with those potential conflicts of interest. The point 2.5 of the IOSCO Code of conduct quoted above is a minimal requirement. The fact that credit rating agencies "prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates" (point 1.14-1) is welcome too. Nevertheless, it is insufficient. Few propositions could contribute to monitor potential conflicts of interest and to reinforce the image of rating agencies independence:

- preliminary ratings should be prohibited. Perhaps rating agencies could argue that such a rule would affect their rating methodologies and deteriorate their rating process. Nonetheless, from my point of view, the practice of preliminary rating is more a commercial tool rather than a part of the rating methodology;
- for rating assessment services, a simple set of rules should be implemented: a formalised issuer's request could be; an explicit statement indicating that the rating assessment does not mean that the effective rating will correspond to the estimated one; the "prohibition" of a rating assessment when the rating agency carries out a rating action; possibly, the disclosure of the rating assessment by the rating agency or the issuer to investors[74]. Consulting services through "independent affiliates" (which, for example, deal with management, strategic risks…) should be at least regulated by a non-overlapping benefits rule (despite implementation difficulties) or prohibited;
- more broadly, an oversight of the rating industry could be useful so as to prevent the development of ancillary services and practices that could create/increase potential conflicts of interest without monitoring. In other words, rather than raising problems once they occurred, it could be more efficient to monitor their development.

C-Transparency, market perceptions and performance

The issues raised in this consultation paper were broadly examined in 2002. Indeed, concerning rating performance, we know, from the history of corporate credit rating, that:

- rating is a relative measure of credit risk[75] that is reliable. Even though some research, comparing ratings to absolute measures of credit risk (which use market

[74] Such disclosure could lead to an infringement of confidentiality requirements.
[75] See for example, this quotation from Moody's Investors Service, 2003, "Measuring The Performance of Corporate Bond Ratings", Special Comment, Global Credit Research, April: "Moody's primary objective is for its ratings to provide an accurate relative ranking of credit risk at each point in time, without reference to an

data[76]), evidence the superiority of the latter [Kealhofer, Kwok and Weng (1998), Delianedis and Geske (1999), Kealhofer (2003)…], according to Moody's[77] (2003) credit rating seems to offer the same power as absolute measures when a long term horizon is retained;

- rating agencies assign "stable" ratings so as not to give "false signals" to investors. According to Moody's (2003), absolute measures of credit risk are much more volatile than ratings.

Concerning the fact that credit rating were based on "incorrect information and faulty or dated models"[78], this criticism partly relies on the quality of the information received by rating agencies as raised in 2002 in the Enron case ! Indeed, the SEC (2003a) noticed that "[A]ccording to the Staff Report, in some cases the rating agencies appeared simply to take the word of Enron officials when issues were raised, and failed to probe more deeply. In addition, the credit rating agency analysts seemed to have been less than thorough in their review of Enron's public filings, even though these filings are a primary source of information for the ratings decision. Among other things, the rating analysts appeared to pay insufficient attention to the detail in Enron's financial statements, failed to probe opaque disclosures, did not review Enron's proxy statements, and failed to take into account the overall aggressiveness of Enron's accounting practices (…) The Staff Report found that the credit rating agencies did not ask sufficiently probing questions in formulating their ratings, and in many cases merely accepted at face value what they were told by Enron officials. Further, the rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, failed to sufficiently consider factors affecting the long-term health of Enron, particularly accounting irregularities and overly complex financing structures."[79] Consequently, if the adoption of "reasonable measures to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating…"[80] could "improve" the situation, it will certainly not resolve issues raised by the quality of information received by rating agencies and market participants in general.

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explicit time horizon (…) Moody's does not manage its rating to achieve accuracy or to maintain constant default rates by rating categories."

[76] The use of market data points out questions related to their informational signification. See for example Lubochinsky (2002). Furthermore, the current turmoil on financial markets raises several questions linked to the meanings of mark-to-market, mark-to-model…

[77] For an absolute measure of credit risk, Moody's employs "bond market-implied ratings".

[78] *In* IOSCO (2008), see footnote 10.

[79] *In* Securities and Exchange Commission (2003a), see footnote 6.

[80] *In* IOSCO (2008), point 1.7, see footnote 10.

Conclusion

Rating is raising a number of issues that are difficult to solve. For example, whatever the regulatory scheme defined, the requirements imposed to rating agencies… criticisms about the fact that rating agencies are too slow to review credit ratings or too quick to downgrade will certainly remain as it is an intrinsic characteristic of rating. Nevertheless, it is possible to improve the rating industry/system by addressing the main issues raised by rating activities.

Indeed, does it make sense to identify the potential conflicts of interest - *e.g.* "the fact that the agencies may have expressed an "ex ante" opinion regarding deal structure suggests that they are providing structure advice"[81] - and the limits of rating in structured finance - *e.g.* "despite the value added by the rating agencies, market participants need to be aware of the limitations of rating"[82] -, and only to deal with them, three years latter, once problems and limits arise?

[81] *In* Committee on the Global Financial System, 2005, "The role of ratings in structured finance: issues and implications", Bank for international Settlements, January.
[82] *In* Committee on the Global Financial System (2005), see footnote 81.

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Wednesday, April 23, 2008

Comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

Dear Mr Tafara,

Despite initiatives like the duopoly relief act in the US the rating market is still dominated by Moody's Investors Service (Moody's) and Standard & Poor's (S&P's). Although market structure is not the primary issue of the consultation report, impacts of any measures taken to regulate the rating agencies on the market form and structure should be considered.

The IOSCO CRA Principles are meant to be high-level and to be used by CRAs of all types and sizes, using all types of methodologies, and operating under a wide variety of legal and market environments. The majority of rating agencies worldwide was not actively involved in the consultation process. Therefore we recommend looking at the many other approaches to credit ratings and ratings on other financial instruments such as mutual funds and insurance policies as well.

In Germany alone, several rating agencies are providing mutual fund ratings, insurance ratings, certificate ratings, and other forms of ratings for securities. **The IOSCO CRA Code of Conduct does not reflect rating agencies of all sizes and business models operating around the world. Since the Code sets a standard for the rating industry, repercussions on related rating activities should be considered.** Similar to credit ratings, e. g. mutual fund ratings are influencing the businesses of investment companies and investors.

Apart from these general considerations, the following points are recommended for review:

1.7 Rating agencies are used to ratings involving types of financial products presenting limited historical data. Although not all of them successful, innovative financial vehicles are commonplace. If CRAs make clear the limitations of the rating and any risks associated with credit ratings of such products, it might be helpful for investor's understanding. Nevertheless, we fear that this requirement of the Code could lead to a wide-spread **disclaimer policy**, which would not serve the market by reducing responsibilities of the rating agencies for their actions. It does not help investors if rating agencies contract out of liability. Rating agencies will use this requirement of the Code to exclude their liability even further.

1.7-2 If CRAs establish **independent functions** responsible for periodically reviewing the methodologies and models and changes to their methodologies and models they use without any external control, there would be little use in such a requirement. Both Moody's and S&P's promised to take actions based on their experiences of the sub-prime crises. The so called "Leadership Actions" taken by S&P's e.g. could rather have a leadership position for S&P's as a result than more competition among rating agencies and an improvement of their services. S&P's "Office of the Ombudsman", "Audit Committee", "Risk Assessment Oversight Committee", "Model Oversight Committee", "Policy Governance Group" are organizational entities which should not be made a prerequisite to any rating agency, but only to those which have a **size and statute appropriate for a more sophisticated organizational structure**. S&P's leadership actions do not lead to a more competitive rating market, but assure S&P's leadership position.

1.7-3 Investors are not best served if CRAs refrain from issuing credit ratings. One rating is better than no rating at all. The question is not "to rate or not to rate", but the **transparency and appropriateness of the rating process and of the criteria applied**.

1.9 The CRA should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings. A key element for the assurance of high quality analysis is the **qualification of rating analysts**. Rating agencies should be encouraged to cooperate with relevant institutions to certify credit analysts and work on minimum requirements (see book "Certified Rating Analyst", www.certified-rating-analyst.eu, Oldenbourg Wissenschaftsverlag, Munich, www.oldenbourg.de, hardback, 1. edition 2008, 562 pages, ISBN 978-3-486-58287-9).

2.8 b. If **smaller CRAs** disclose if it receives 10 percent or more of its annual revenue from a single issuer, originator, arranger, client or subscriber, it makes them **more vulnerable to competition**, since transparency would be increased mainly among smaller agencies.

2.8 c. We doubt that it is meaningful to let each CRA disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure. This requirement **would help Moody's and S&P's**, since issuers would be reluctant to let disclose that they did not contract with a CRA for a final rating, but did contract with another CRA for a final rating of that same product. Most issuers would not ask smaller rating agencies any more since they would fear that they get misunderstood in the market if they contract with another CRA afterwards. They same is true if contracts with a CRA for a final rating have to be disclosed in the case that the client does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.

3.5 b. A CRA should disclose whether it uses a separate set of symbols when rating structured finance products, and their reasons for doing so or not doing so. Since there is no **standardization of rating symbols**, adding new symbols could be confusing for the market. New symbols should be introduced after an effort to standardize existing ones. We have seen no significant initiatives neither at Moody's nor at S&P's to discuss or overcome problems of their rating models and procedures by consulting with relevant associations such as DVFA (www.dvfa.de), BdRA (www.bdra.de), ISO (www.iso.org) or others. CRAs should be encouraged not only to define given rating symbols and apply them in a consistent manner for all types of securities to which those symbols are assigned, but also to cooperate to standardize existing rating symbols where possible.

3.5 c. By cooperating in projects like the one of the Project Committee on Rating Services at the **International Organization for Standardization (ISO)**, CRAs could assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. Standardization would help market participants a lot to understand the attributes and limitations of each credit opinion, and the limits to which the CRA verifies information provided to it by the issuer or originator of a rated security.

Best regards,
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April 25, 2008

Via Electronic Mail

Mr. Greg Tanzer
Secretary General
The International Organization of Securities Commissions
Oquendo 12
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Spain

Re: Comments on the IOSCO Technical Committee Consultation Report on Credit Rating Agencies

Dear Mr. Tanzer,

On behalf of Rating and Investment Information, Inc. ("R&I"), I appreciate this opportunity to comment on the Technical Committee of the International Organization of Securities Commissions' ("IOSCO Technical Committee") consultation report regarding "The Role of Credit Rating Agencies ("CRAs") in Structured Finance Markets" ("Consultation Report"), which includes proposed amendments to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code of Conduct").

R&I, headquartered in Tokyo, Japan, is one of the largest rating agencies in Asia and is a respected independent source of financial information for investors, underwriters and other market participants in Japan as well as other overseas markets. R&I is registered as a Nationally Recognized Statistical Rating Organization ("NRSRO") with the U.S. Securities and Exchange Commission, contributes to the regulatory authority in Japan as a Designated Rating Agency, and is recognized as an External Credit Assessment Institution for Basel II purposes in Japan as well as in Hong Kong. I hope that our comments will be of assistance to the IOSCO Technical Committee.

R&I generally supports the IOSCO Technical Committee's proposed amendments to the IOSCO Code of Conduct, however, for the reasons described below, R&I disagrees with and/or requests clarification of certain required elements of the proposed amendments.

Provision 1.7

The IOSCO Technical Committee proposed that Provision 1.7 of the IOSCO Code of Conduct include the following additional language:

"The CRA should adopt reasonable measures to ensure that the information it uses in assigning a rating is of sufficient quality to support a credible rating. If the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the CRA should make clear, in a prominent place, the limitations of the rating and any risks associated with credit ratings of such products."

We respectfully propose that the IOSCO Technical Committee delete the phrase "and any risks associated with credit ratings" from the proposed amendments to Provision 1.7. Such language would require credit rating agencies to list all of the risks associated with credit ratings, including trivial ones, which could make it difficult for investors to identify the essential risks associated with the ratings of such products.

Provision 1.7-2

The IOSCO Technical Committee proposed that the following provision be added as Provision 1.7-2 to the IOSCO Code of Conduct ("Provision 1.7-2"):

"*The CRA should establish an independent function responsible for periodically reviewing the methodologies and models and changes to the methodologies and models it uses.*"

R&I supports the proposition that CRAs should periodically review the methodologies and models and changes to the methodologies and models they use. The business environment and financial resources, however, differ among CRAs. Proposed Provision 1.7-2 could hamper competition in the rating industry because only a few large CRAs with robust financial resources would be able to comply with the proposed provision. Therefore, R&I respectfully proposes that the word "independent" be deleted from Proposed Provision 1.7-2 in order to provide flexibility among the CRAs.

Alternatively, R&I respectfully proposes that proposed Provision 1.7-2 be revised as follows:

"*The CRA should provide for formal, periodic, internal reviews of new rating criteria and methodologies and significant changes to rating criteria and methodologies and the objective assessment of criteria and methodologies based on historical credit rating experience, when available.*"

Provision 1.7-3

The IOSCO Technical Committee proposed that the following provision be added as Provision 1.7-3 to the IOSCO Code of Conduct ("Provision 1.7-3"):

"*The CRA should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credit rating for the security that fits within its established categories of credit ratings, CRA should refrain from issuing a credit rating.*"

R&I believes that the decision of a CRA as to whether to assign ratings on certain products should be left to CRAs. In certain instances, CRAs will use new methodologies to rate new products. R&I believes that prohibiting CRAs from issuing a credit rating on a particular security could adversely affect financial innovations and is not desirable for the healthy development of capital markets.

The IOSCO Technical Committee does not define the term "categories" within Provision 1.7-3. If the IOSCO Technical Committee intends "categories" to mean rating symbols such as "AAA" or "BBB," R&I supports the proposed Provision 1.7-3. If, however, the IOSCO Technical Committee intends "categories" to mean "ratings for product types," R&I respectfully proposes that the phrase "that fits within its established categories of credit ratings" be deleted from Provision 1.7-3 and that the following language be added to the end of the provision: "if the CRA does not believe that such a rating is feasible."

Provision 1.9-1

The IOSCO Technical Committee proposed the following provision be added as Provision 1.9-1 to the IOSCO Code of Conduct ("Provision 1.9-1"):

"*If a CRA uses separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products, each team should have the requisite level of expertise and resources to perform their respective functions in a timely manner.*"

R&I fully respects the importance of monitoring and updating its ratings. Due to the differences between the business environments and the financial resources among CRAs, however, R&I believes that each CRA should be allowed to develop its own monitoring system. R&I also believes that the proposed provision should permit flexibility for CRAs in order to avoid excessive burdens on relatively small-sized CRAs.

For the aforementioned reasons, R&I respectfully proposes that the proposed Provision 1.9-1 be modified as follows:

“*The CRA should establish separate teams for assigning initial credit ratings and for conducting ongoing surveillance of structured finance transactions, whenever feasible.*”

<u>Provision 1.14-1</u>

The IOSCO Technical Committee proposed that the following provision be added as Provision 1.14-1 to the IOSCO Code of Conduct (“Provision 1.14-1”):

“*A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.*”

While R&I agrees in principle to proposed Provision 1.14-1, R&I respectfully proposes that the following language be added to the end of proposed Provision 1.14-1:

“In assessing the credit risk of a structured finance transaction, the CRA’s analysts may properly hold a series of discussions with the issuer or its advisers in order to: 1) understand and incorporate into their analysis the particular facts and features of the structured finance transaction, and any modification, as proposed by the issuer or its agents; and 2) explain to the issuer or its agents the credit rating implications of the CRA’s methodologies as applied to the issuer’s proposed facts and features.”

R&I believes that our proposed additional language would allow proposed Provision 1.14-1 to become functional and would lead to improved quality in structured finance ratings.

<u>Provision 2.8(c)</u>

The IOSCO Technical Committee proposed that the following language be added as 2.8(c) to the IOSCO Code of Conduct (“Provision 2.8(c)”):

“*A CRA should disclose on a periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating of that same product; or (2) contracts with the CRA for a final rating and does not publish the CRA’s final rating, but does publish the ratings of another CRA for that same product.*”

R&I believes that CRAs should be able to disclose the number of cases which fall under the categories of (1) and (2) above, but that CRAs are generally not allowed to disclose the details of each case pursuant to confidentiality agreements with clients. As it will be rather difficult for CRAs to comply with the proposed language, R&I respectfully proposes that the following language be added to proposed Provision 2.8(c) (proposed language is <u>underlined</u>):

“*A CRA should<u>, where feasible given its relationship with its clients,</u> disclose on a* *periodic basis all cases during the timeframe in question where an originator, underwriter or sponsor of a structured finance product has provided the CRA with final data and information about a proposed structure and asked it for a preliminary rating of the proposed structure, but: (1) does not contract with the CRA for a final rating, but does contract with another CRA for a final rating of that same product; or (2) contracts with the CRA for a final rating and does not publish the CRA's final rating, but does publish the ratings of another CRA for that same product.*"

Provision 2.11(b)

The IOSCO Technical Committee proposed that the following provision be added as Provision 2.11(b) to the IOSCO Code of Conduct ("Provision 2.11(b)"):

"*The CRA should conduct formal and periodic reviews of compensation policies and practices for CRA employees to ensure that these policies and practices do not compromise the CRA's rating process.*"

R&I believes that the scope of "CRA employees" is too broad and that employees working in divisions not involved in the rating process should be exempted from such compensation reviews. R&I respectfully proposes that such compensation reviews be confined to "analysts and other CRA employees who are eligible to participate in rating committees."

Provision 2.17

The IOSCO Technical Committee proposed that the following provision be added as Provision 2.17 to the IOSCO Code of Conduct ("Provision 2.17"):

"*The CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join an issuer the CRA rates or has rated, or a financial firm with which the CRA has significant dealings.*"

R&I believes that the scope of "look-back" reviews as proposed in Provision 2.17 is too broad. R&I believes that it should be sufficient if "look-back" reviews are conducted only when an analyst leaves the CRA and joins (a) an issuer for whom such analyst acted as the lead-analyst or as a support-analyst, or (b) a financial firm which acts as a rating advisor. Accordingly, R&I respectfully proposes that proposed Provision 2.17 be modified as follows (proposed language is <u>underlined</u>):

"*The CRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA and join (a) an issuer <u>for whom such analyst acted as the lead-analyst or as a support-analyst, or (b) a financial firm which acts as a rating advisor</u>.*"

Provision 3.3

The IOSCO Technical Committee proposed that Provision 3.3 of the IOSCO Code of Conduct ("Provision 3.3") be amended as follows:

"*The CRA should indicate with each of its ratings when the rating was last updated. Each rating should also indicate the principal methodology or methodology version that was used in determining the rating.*"

CRAs use a wide range of rating methodologies for corporate bonds. To require CRAs to list all the methodologies used in determining the rating for corporate bonds is not practical. On the other hand, if CRAs are required to indicate only the principal methodologies used, it might cause investors to not pay due attention to other risks that are excluded by such principal methodologies. Consequently, R&I believes that the scope of amended Provision 3.3 should be limited to the ratings of structured finance products. R&I respectfully proposes that the amendments to Provision 3.3 be modified as follows (proposed language is <u>underlined</u>):

"*Each rating <u>of structured finance products</u> should also indicate the principal methodology or methodology version that was used in determining the rating.*"

Provision 3.5(a)

The IOSCO Technical Committee proposed that the following language be added as Provision 3.5(a) to the IOSCO Code of Conduct ("Provision 3.5(a)"):

"*Where a CRA rates a structured finance product, it should provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis so that an investor allowed to invest in the product can understand the basis for the CRA's rating.*"

While R&I agrees that CRAs should provide sufficient information to investors and /or subscribers, R&I respectfully proposes that the phrase "about its loss and cash flow analysis" be deleted from proposed Provision 3.5(a). Originators may prohibit CRAs from disclosing information, such as default ratios, about underlying assets. In addition, what constitutes a "sufficient" level of information may vary depending on the types of underlying assets and therefore, providing such information in a standardized format might be difficult.

Provision 3.5(b)

The IOSCO Technical Committee proposed that the following language be added as Provision 3.5(b) to the IOSCO Code of Conduct:

"*The CRA should disclose whether it uses a separate set of symbols when rating structured finance products, and their reasons for doing so or not doing so. In any case,* *a CRA should clearly define a given rating symbol and apply it in a consistent manner for all types of securities to which that symbol is assigned.*"

R&I believes that each CRA should be allowed its own response to this point according to the market environments they are in. The market environments in Japan is different from those in the United States in the sense that in Japan (1) ratings on products involving subprime mortgages do not exist, (2) information fraud has seldom happened to the best of our knowledge, and (3) ABS CDOs scarcely exist. R&I believes that we should respond to our own market environments where a sound structured finance product market is maintained and abrupt and substantial downgrades of the ratings of the same types of securitized products seen in the United States have not happened. Based on the lessons learned in the United States as a result of subprime mortgage problems and the resulting diminished credibility of credit ratings, R&I believes that we should positively and swiftly implement measures in Japan to prevent such problems. Currently, our understanding is that there are few investors, arrangers or credit analysts in Japan who support the idea of differentiating rating symbols of structured finance products.

R&I offers its ratings as a common measuring scale concerning the credit risk of debt investment instruments in order to meet the needs of investors who wish to construct a portfolio crossing different industrial sectors or different types of investment instruments. If R&I provided a different category of ratings solely for structured finance products, investors who hold a wide variety of investments would require another measuring scale which would connect the structured finance products with the conventional one. This eventually leads to the evaluation of structured finance products and other investment instruments using a common measuring scale. R&I believes that CRAs and the arrangers must make consistent efforts to explain to market participants the intrinsic value of ratings, *i.e.*, ratings are the common measuring scale of credit risk. R&I has been, and will be making such efforts to explain the risk profile of structured finance products and the implication of its ratings. Consequently, investors will make use of ratings as a valuable measurement tool of credit risks.

Provision 3.5(c)

The IOSCO Technical Committee proposed that the following language be added as Provision 3.5(c) to the IOSCO Code of Conduct ("Provision 3.5(c)"):

"*The CRA should assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put to use vis-à-vis a particular type of financial product that the CRA rates. A CRA should clearly indicate the attributes and limitations of each credit opinion, and the limits to which the CRA verifies information provided to it by the issuer or originator of a rated security.*"

R&I agrees that CRAs should assist investors in developing an understanding of the attributes and limitations of ratings and respectfully proposes that the following disclaimer be considered a satisfactory response to the aforementioned provision:

"*Credit ratings are opinions regarding the relative future credit risk of an entity, a credit commitment, or a debt or debt-like security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk or price volatility risk. Credit ratings are not a recommendation to buy, sell or hold any securities. In connection with their ratings analysis, CRAs rely on the information provided to them that is believed to be accurate and reliable and do not undertake any independent verification of the accuracy of that information.*"

Furthermore, CRAs are not in a position to "verify" the information provided to them by originators. Consequently, R&I also respectfully proposes that the word "verifies" in proposed Provision 3.5(c) be changed to "reviewed" as it more accurately reflects the practices of CRAs.

Provision 3.8

The IOSCO Technical Committee proposed that the following language be added to Provision 3.8 of the IOSCO Code of Conduct ("Provision 3.8"):

"*This information should include verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.*

R&I will endeavor to ensure the comparability of rating performance data among CRAs. At this moment, however, R&I believes it rather premature to standardize the information on rating performances as the phrase "where possible" might so indicate.

* * *

Although ratings on products involving subprime mortgages do not exist in Japan, as noted in our comments on Provision 3.5(b), R&I will nonetheless positively and swiftly respond to the proposed amendments to the IOSCO Code of Conduct in order to further the sound development of the structured finance product market.

For further information or clarification regarding our comments, please feel free to contact me at yharada@r-i.co.jp or Mr. Masahiro Kambe at mkambe@r-i.co.jp.

Sincerely,

Y. Harada

Yasuhiro Harada
Chairman and Co-CEO
Rating and Investment Information, Inc.

Public Comment on The IOSCO Technical Committee Consultation Report on Credit Rating Agencies

by Richard Hainsworth CFA, CEO RusRating[1]

Comments have been sought as to whether the Consultation Report correctly analyses the role of credit rating agencies in structured finance markets and on the proposed recommendations for modifying the IOSCO Rating Agencies' Code of Conduct.

The analysis of the role of CRAs in the structured finance markets is by and large correct, though missing an important element. The market relationships between market players – the rating agencies, regulators, investors, investment banks – have been correctly identified.

Our primary concern is that the combination of the analysis and the amendments to the Code of Conduct implies a judgement that it was the improper behaviour within the rating agencies that triggered or was a major factor in the "Sub-Prime" crisis. Following this logic, the Code needs to be tightened to avoid future improprieties.

We argue that the fundamental problem in the rating agency market today and the root cause of the crisis is its over-concentration. Concentration is mentioned in the Report – compared to the thousands of investors and banks, only three organisations issue ratings that are widely quoted. Given the importance of ratings in the modern financial world, this is a dangerous dependence.

No matter how much the governance and methodologies of the Big-3 rating agencies are tweaked, the assignment of ratings is by definition subjective, and so all agencies will get it wrong sometime. If the entire market continues to rely only on three agencies, the frequency that all will "get it wrong" together will be large, and crises will be commonplace. To avoid and ameliorate this risk, the oligopoly in the rating agency market must be dissipated.

The suggested changes to the Code of Conduct appear to us, as a small rating agency, to increase the burdens for compliance. While the changes will not be difficult for the largest rating agencies, they will materially add to the cost base for small agencies. We comment in detail on some of the changes below. Because these amendments in the Code of Conduct favour large agencies, they will – in the long run – be counter-productive as they will prolong the current over-concentration in the industry.

The missing element in the analytical section of the Report concerns new rating products, although the Report does look at new products and the defective ratings that lie at the heart of the sub-prime crisis. The crucial concept here (developed for domestic recognition by the Russian rating agencies) is the **rating dimension**. It is the abstract line along which a financially important variable such as

1 RusRating is a credit rating agency formed in Russia in 2001 to provide research and assign ratings on Russian banks. Its revenues come from subscriptions to its research products and rating mandates. Subscription clients include IFC, EBRD, US ExImBank, and global banks regulated in the USA, Germany, Japan, Singapore, Italy, and the UK. RusRating operates in Russia, but is actively supporting the creation of similar agencies in Kazakhstan, Armenia, and Azerbaijan. Its English-language website is www.rusrating.ru/en/

credit risk is measured and explicitly both qualitative and quantitative components are involved in placing a rating object in any interval of the rating dimension. The concept was developed because other types of ratings will be developed in the future: liquidity risk ratings, investment attractiveness ratings, operating risk ratings, etc. Moreover, a true rating cannot simply be calculated by a computer program. We argue that both the rating agency and the rating dimensions it uses should be recognised (certified) separately.

A rating agency clearly has to have competent staff and business processes to assign ratings and obtain and maintain credibility. The Code of Conduct as it stands adequately describes what is necessary in this respect. In order to rate anything, an agency must have a methodology associated with at least one rating dimension. But having obtained credibility as a rating agency does not mean the company has carte blanche to invent new rating dimensions and apply them at will.

A new rating product may be associated with the rating dimension(s) an agency has already worked with, or it may be a product associated with a completely new rating dimension. For example, risk factors for railways differ to some degree to those for manufacturing companies, yet they are weighed in the same manner and the issues to be judged are similar. An agency that succeeded in rating railway bonds could go on to rating other company's bonds, just as John Moody successfully did at the outset of the rating industry. Clearly the “new product” was not so dissimilar to the initial product. We argue that the same rating dimension is involved. Rating agencies should be able to extend their operations to other sectors, so long as they are operating with the same rating dimension.

The rating of a pool of loans to different borrowers is, however, fundamentally different to the rating of a single borrower (debt issuer). Whereas a single issuer may be affected by general economic factors, for a pool of similar issuers, the effects will be averaged over the pool and thus the characteristics of a pool will be fundamentally different to those of a single issuer. Moreover, very significant risk factors are involved in the structuring of the legal and tax treatments of the entities that hold the pools as assets. Consequently, the credit risk of securities deriving from pools of primary debt instruments belongs to a different rating dimension than the credit risk of a single issuer.

Furthermore, a pool of assets that are themselves financial instruments is also very different from a pool of homogeneous primary issuers. Here the assumptions of the mathematical model describing the behaviour of the interactions between pools become risk factors in themselves. This is yet another rating dimension.

This distinction between different types of new rating products and extensions of exiting dimensions needs to be much more clearly spelt out in the Code of Conduct. What has happened to date is that the Big-3 have demonstrated historically high levels of reliability when dealing with credit risk of primary issuers (one rating dimension), even though they have gradually extended the application of their methodologies to different countries and different sectors of the economy. They have arbitraged this reputation into the rating of tranches of structured products (other rating dimensions). The rating methodologies for the new rating dimension (for structured products) are defective, and the consequence is to throw into doubt **all** previous rating methodologies, thus damaging overall market stability.

To prevent this from happening again, the Code of Conduct should make the introduction of new rating dimensions more difficult and only after significant public testing of the methodology and the underlying theory. Whilst at the same time, new rating products based on existing methodologies and rating dimensions should not be constrained by burdensome restrictions. Clearly, a judgement needs to be made by an independent authority as to whether a new product involves a new or existing rating dimension.

The same differentiation could also be extended to new rating agencies. Where the new agency is applying a well-understood rating dimension, such as credit risk for publicly traded debt instruments, the acceptance of the agency should be encouraged – to increase market diversity.

The Consultation Report mentions an extremely important characteristic of the ratings market – official recognition. We strenuously emphasise this finding. There are fundamentally two stable configurations for a financial market: "few ratings" and "many ratings". Where there are few ratings, only good institutions will voluntarily want ratings, primarily as a means to distinguish themselves from the competition. Bad institutions will avoid ratings. Since there are only a few ratings, investors and regulators will develop techniques that are independent of public ratings. Good, but cost-conscious, institutions will not see a benefit from a rating in such a market. Consequently, the configuration is stable: a low-rating configuration will not evolve naturally to a high-rating configuration. Conversely, when there are many ratings, the absence of a rating is meaningful and all companies undertake a rating process as the entrance price to the market. Thus "many ratings" is also a stable configuration.

Clearly, where there are public risk measurements, in the form of ratings, for nearly all issuers (borrowers) investors can distribute resources more cost-effectively. The "many ratings" configuration is beneficial – in essence a public good. But because both configurations are stable, an external force is needed to switch the market from one configuration to the other. This requires governmental intervention. Ratings must be made desirable for the market.

We argue that the creation by the SEC in the USA of the NSRSO designation was the trigger mechanism in that market to move it to the "many ratings" configuration. We suggest that a similar trigger is needed in Europe and in other markets.

Many governments have recognised the need for ratings, but few have the resources or sophistication to ensure the development of rating agencies that can provide credible ratings. They rely on accreditations outside their own jurisdictions. Moreover, demanding ratings without providing the conditions for the creation of a rating agency is also self-defeating (several countries have tried this).

Furthermore, we argue that with the increased reliance on credit ratings in the financial world (we make reference to Basel-II and the implications of IFRS-7), the demand for ratings in Europe is going to grow. It will not be possible for three rating agencies to handle the demand. Hence, the problem facing the global financial markets is not just decreasing concentration in the rating agency industry because it is dangerous for so much reliance to be placed on only three sources; there is a real need to establish the conditions within which many more rating agencies can grow and develop to meet the needs of the financial markets.

From the viewpoint of a small rating agency operating in an emerging market, we offer specific comments on a few of the proposed amendments:

1. **Separate teams for determining and monitoring ratings**. Such a provision would double the number of analysts and the intellectual effort needed to rate any single entity or financial instrument. A large rating agency, such as one of the Big-3, will have no difficulty simply reassigning existing resources. A small agency would need to hire more staff. The problem

being addressed here is how to ring-fence the decision-making process from the fee-paying client, especially when the fees are a material proportion of the Agency's revenues. Adding staff will not reduce this problem because the ratings are issued as a corporate entity, not by competing teams. Suppose one team decides to downgrade as soon as it takes over the monitoring of a rating. Would a rating agency – as a corporate entity – allow that to happen? What would such a downgrade say about the value of the original rating? If the rating agency had such strong and independent analysts capable of forcing a re-rating, then its initial rating process would also be strong and the parallel teams would be unnecessary. We argue that market forces and the need for rating agencies to distinguish themselves by reputation is a better mechanism for increasing quality and independence.

2. **Independent model review function.** Methodologies and models constantly need to be reviewed. Quality depends on it. But why would quality necessarily be affected by "independent" review? Most often, it is the working analysts who become aware of flaws in a methodology and who can institute changes. We suggest two reasons for this focus on a methodology review:
    1. One of the Big-3 underwent a massive shift in its methodological stance, taking the market by surprise. The only reason that this had any effect on the market as a whole was because of the oligopolistic nature of the market and the dominance of that agency – consider how a similar change would have affected the market had there been five or six agencies, and not just three. Once again, the problem is not internal to the agencies, but a problem due to the structure of the market.
    2. The methodologies and models used to rate structured products were defective from the start. But that does not mean that the methodologies for rating debt instruments are defective. We argue that this distinction is due to different rating dimensions. Thus the focus of the change in Code of Conduct needs to focus on this distinction rather than on a review of methodologies.
3. **Information quality.** In our operating areas, information quality is a fundamental problem. Often it simply does not exist, even within the institution being rated! Assessing information quality and incorporating it into the rating is a part of our rating process. The recommended change in the Code is flawed in concept: it is assumed that a credible credit rating can only be assigned when there is full information of good quality. A **high** rating clearly cannot be assigned in the absence of good quality information. But a low rating can be assigned, the absence or paucity of information in itself being a source of risk that is being rated.

Conclusion

The Code of Conduct as originally published is an extremely powerful and elegant document. Had the provisions of the Code of Conduct been aggressively applied and non-compliance brought with it penalties for the erring rating agency, the improprieties in the behaviour of the Big-3 as documented and acknowledged would have been less severe.

Yet the root cause of the crises rocking the financial world lies in the structure of the rating market – its concentrated structure and the ability of the Big-3 to distance themselves from the Code of Conduct. Consequently, it is not the Code of Conduct itself that requires change, but the market structure that must be changed and the mechanism for ensuring compliance with the Code.

An internationally recognised certification authority is required that can determine whether rating agencies are in compliance with the Code of Conduct, can apply penalties for non-compliance, and can certify the rating dimensions that a rating agency is recognised to apply. Moreover, any benefit accruing to the presence of a rating, e.g., its regulatory use for the purposes of Basel-II or IFRS 7, should be made dependent on the rating dimension and the rating agency that assigned the rating beginning certified by this authority.

CNMV's CONSULTATIVE PANEL RESPONSE TO THE IOSCO CONSULTATION ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS

The CNMV's Consultative Panel has been set by the Spanish Securities Market Law as the consultative body of the CNMV This Panel is composed by market participants (members of secondary markets, issuers, retail investors, intermediaries, the collective investment industry, etc) and its opinions are independent from those of the CNMV.

The CNMV's Consultative Panel welcomes the efforts by IOSCO to update the Code of Conduct for CRAs and the release of this consultation paper. The Panel's comments are of two types. Firstly, a more general reflection, followed by a number of suggestions in connection with specific aspects of the IOSCO Code of Conduct.

The current financial crisis has revealed serious weaknesses in the working of the CRAs which have undermined investor confidence. The CRAs play a major role in the financial world since many players rely on their ratings. Moreover, a number of regulations, such as Basel II and those governing UCITS investment policies, accept CRA ratings as a valid benchmark and assign a major role to them. Accordingly, the CRAs activity can have potential systemic effects with an impact on financial stability.

Consequently, the CNMV's Consultative Panel considers that, independently of updating the Code of Conduct (which is advisable), IOSCO should consider the possibility of recommending the development and implementation of some type of regulation and of setting an appropriate oversight of the compliance of the CRAs with such regulation. This regulation could be based on the IOSCO Code of Conduct but should go further by detailing the requirements to be met by the CRAs, covering all aspects of their activities.

Nevertheless, this Panel considers it would be appropriate to take certain aspects into consideration in order to avoid any deleterious impact on investors and the fixed-income market. These comments are focused in the following six issues:

1. Discontinuation of ratings

The CRAs can discontinue their ratings. Although it is generally accepted that such action should only take place in extraordinary circumstances, the Panel considers that it is necessary to limit the reasons for such action and to delimit the reasons setting objective circumstances.

The Code of Conduct sets out certain obligations with respect to assigned ratings (items 1.9, 1.10 and 2.1) but we consider it is necessary to include additional limitations

2. Suspension of methodologies

Several CRAs have suspended a number of rating methodologies in the recent past. These events have increased investor uncertainty about bonds and represent a breach of the requirements of Basel II with respect to the requirement of "objectivity". We consider that the CRAs assume a number of stress scenarios, even at favourable times in the cycle, and, although it is recommendable that they adapt to the market situation, suspension of methodologies should be kept to a minimum.

It is advisable to establish the extraordinary reasons that warrant suspension, the disclosure procedures and the periods of suspension.

Item 3.10 of the Code of Conduct establishes the principles governing methodologies. We believe that such methodologies may need to be adapted on the basis of market developments and the calibration of additional risks.

3. Model calibration

Although the Code of Conduct (items 1.7 - 3) states that models must consider the underlying assets, we believe it is important to stipulate that the specific features of each legislation and market (national, regional, sectoral, etc.) need to be evaluated.

4. Studies and publications

There is no oversight of CRAs' publications, and it is necessary to establish mechanisms for supervision and even discipline in the event of harm to market participants.

For example, certain recent publications did not specify the entities to which they referred, that created widespread problems in certain sectors, as reflected in losses in equities and mistrust of those sectors' bonds in the fixed-income market.

The current Code of Conduct sets out reporting obligations (item 1.10) but we believe it is necessary to add certain aspects to ensure that CRA disclosures are clear and unambiguous.

5. Conflicts of interest

The CRAs offer models for capital adequacy in the various sectors (pricing and rating models). It is necessary to clearly delimit these consulting functions from the rating functions.

Besides, the more entities and/or structures that the CRAs rate, the greater their revenues are. Clients often make publication of the rating conditional upon it being satisfactory to them; therefore, there may be a bias in published ratings.

Item 2.5 of the current Code of Conduct regulates a clear separation between revenues from these services and the analysis of risk, but we consider that there should be greater emphasis on distinguishing and separating consulting serveces and the sale of management tools, on the one hand, from the process of rating, on the other.

6. Different scales depending on product type

The CNMV’s consultative panel considers that there should be different rating scales for different types of products, thus providing distinct treatment for structured products.

<u>Comments on IOSCO Code of Conduct for Credit Rating Agencies (Revised February 2008) by the Securities and Exchange Commission of Thailand</u>

1. **<u>Quality and Integrity of the Rating Process</u>**

There are serious questions whether credit ratings given to structured finance products or RMBS really reflect related risks. A sponsor generally initiates the RMBS rating process by sending the CRA data on pool of loans (e.g. borrower's credit history, loan to value ratio). However, we are uncertain whether CRAs look into details of the process, the quality and the criteria used by the originator when giving out loans to borrowers. In the case of subprime CDOs, it appears that there were too many mortgages originated that were for speculative fourth, or fifth homes. And there were too many mortgages that borrowers simply stated their income without any proper verification.

Therefore, we recommend the draft IOSCO Code of Conduct to include the CRAs' responsibilities to review the due process of the loan origination as well. Such issue may be added in the quality and integrity of the rating process part.

2. **<u>CRA Responsibilities to the Investing Public and Issuers</u>**

The draft IOSCO Code of Conduct item 3.5 b. states that the CRA should disclose whether it uses a separate set of symbols when rating structured finance product, and their reasons for doing so or not doing so.

We strongly support the idea that a different set of symbols should be used by CRA for structured product ratings, given the fact that structured product has different risk characteristic and rating methodology compare to plain vanilla corporate bonds. By differentiating a set of symbols, investors would be able to clearly distinguish the rating of the structure products thereby enable them to make proper investment decisions.

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN • BUNDESVERBAND DEUTSCHER BANKEN E. V. BERLIN • BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E. V. BERLIN • DEUTSCHER SPARKASSEN- UND GIROVERBAND E. V. BERLIN-BONN • VERBAND DEUTSCHER PFANDBRIEFBANKEN E. V. BERLIN

Comments of the Zentraler Kreditausschuss[1] on the consultation report by the International Organization of Securities Commissions (IOSCO) "The Role of Credit Rating Agencies in Structured Finance Markets"

25 April 2008

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[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the co-operative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the mortgage banks. Collectively, they represent more than 2,200 banks.

The Zentraler Kreditausschuss (ZKA) welcomes the opportunity to respond to the consultation report by the IOSCO Technical Committee: "The role of credit rating agencies in structured finance markets". Our comments on the report's analysis and proposed amendments to the IOSCO Code of Conduct Fundamentals are set out below.

I. General comments

Our members take the view that credit rating agencies (CRAs) generally provide a valuable service. Nevertheless, the financial turmoil since summer 2007 has shown that certain shortcomings exist regarding rating methodologies, transparency and the management of potential conflicts of interest, especially in the market for structured finance products. These shortcomings must be remedied since a great many investors base their decisions on credit ratings and this, in turn, has implications for banks' funding costs.

It is first and foremost up to the CRAs themselves to address this task. Nevertheless, we believe there is a need to adjust the regulatory framework for CRAs too. CRAs need to be set high standards concerning quality, diligence, independence and transparency. This is not least because ratings are not only important for the smooth functioning of the financial markets but are also often used as a yardstick in legislation. Lawmakers, financial regulators and central banks are making increasing use of credit ratings. One example is their use in calculating capital requirements. The German banking industry has reservations about this development. Lawmakers and regulators should investigate the possibility of drawing on alternative measuring tools.

We therefore warmly welcome the fact that IOSCO is planning to revise its Code of Conduct Fundamentals with the aim of eliminating these problems or at least reducing them to an acceptable level.

In its comments of 8 November 2004 the ZKA already pointed out that the Code was not in any way binding. The oligopolistic conditions in the ratings market also need to be taken into consideration. Our members believe that the recent events in the financial markets are not in themselves a reason to abandon the current regulatory approach. This position is subject, however, to every effort being made to ensuring globally uniform, widespread, formal and concrete implementation of the Code by CRAs under the "comply or explain" approach. For this reason, we see a need for a regular external monitoring process which is based on industry-wide standards and covers rating methodologies and models as well as internal governance. It remains to be examined whether a separate, independent institution is required for this purpose. Market participants should also be involved in the process. It is important, too, for CRAs to make the same information available to all relevant supervisory authorities. Key to the smooth functioning of this system, moreover, is that CRAs actually apply the provisions of the IOSCO Code on a day-to-day basis.

IOSCO's analysis as set out in the consultation report largely coincides with the views of the German banking industry. We comment below on the questions raised by the report and on the proposed amendments to the Code. Our comments are confined to those passages which we feel are in need of some adjustment.

II. Comments on IOSCO's recommendations

1. Definitions

Some of the proposed additions to the IOSCO Code specifically target structured finance products. Given that "structured finance product" is often used to mean different things, we believe it is essential to begin by defining what is to be understood by the expression. We would therefore suggest including a definition of "structured finance product" in the "Terms" section. This will eliminate any uncertainty concerning exactly which products are covered by certain provisions.

In particular, it should be clarified that covered bonds, such as Pfandbriefe, are not structured finance products. Pfandbriefe are collateralised bank bonds; the bank is the issuer, the collateral remains on its balance sheet and there is no tranching. Pfandbriefe and other covered bonds are therefore quite different from typical structured products of the kind described on page 9 of the consultation report. In our view, an appropriate definition may be found in paras 35 and 36 of CESR's consultation paper: "The role of credit rating agencies in structured finance"[2].

2. Quality and integrity of the rating process

We suggest specifying in para 1.4 that experienced senior analysts should always be involved in rating decisions.

In the final sentence of para 1.7, the term "structured products" should be used instead of "financial vehicle" since the provision refers to innovative products.

The first sentence of para 1.7-3 should be changed to read as follows: "The CRA should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying *the respective* structured product change materially." We then suggest inserting a sentence along the following lines: "CRAs should not only examine whether material changes in the risk characteristics of securitised portfolios have implications for existing methodologies and models but should also, if necessary, respond by adjusting their methodologies accordingly within a reasonable period of time."

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[2] CESR, "The role of credit rating agencies in structured finance"; consultation paper; February 2008; p. 8.

3. CRA independence and avoidance of conflicts of interest

We basically support the addition of the final sentence to para 2.5. It is essential, however, for the definition of “ancillary business” to be absolutely unequivocal. We would therefore recommend amending the sentence as follows: “The CRA should also define *precisely* what it considers to be an ancillary business and why.”

In view of the oligopolistic structure of the ratings market we believe it is highly important for fee structures to be completely transparent. A key point, in this context, is transparency regarding the composition of fees. We therefore suggest that para 2.8-a. should require CRAs not only to indicate the proportion of income derived from non-rating activities but also to disclose their complete fee structure, including any changes in fees.

The purpose of para 2.8-c. seems reasonable enough at first glance. Practical implementation of these provisions is likely to raise a number of questions, however. The term “final data”, for instance, is ambiguous, thus making it unclear exactly when a request for a rating of a particular structure should be reported as having been terminated. What is more, CRAs will find it very difficult to ascertain whether the structure of a product has been modified in the period between a request for a rating being withdrawn and an official rating being issued by another agency. There are important reasons apart from “rating shopping” why an issuer, sponsor or originator may refrain from concluding a contract with a CRA even though it has already issued an indicative rating. Detailed disclosure could damage the reputation of issuers and would raise data protection concerns. This information should therefore only be made available in aggregated and anonymised form.

4. CRA responsibilities to the investing public and issuers

A mapping of ratings and rating methodologies should always be carried out. The process should be completely transparent since this is the only way to allow detailed evaluation. The final sentence of para 3.3 should therefore read as follows: “Each rating should also indicate the methodology and its version that was used in determining the rating.”

We suggest changing the wording of para 3.5 as follows in the interests of greater precision: “The CRA should publish sufficient information *so that outside parties can understand how a rating was arrived at by the CRA. This information should consist of* procedures, methodologies, and assumptions (including financial statement adjustments that deviate materially from those contained in the issuer’s published financial statements and a description of the rating committee process, if applicable) *as well as the sensitivity of the outcomes to small changes in the assumptions (for example on correlation and on stress tests)*. Further, this information will *include* (but not be limited to) the meaning of each rating category, the definition and *probability of* default or recovery, *accompanied by* the time horizon the CRA used when making a rating decision. *In addition, more clarity should be provided regarding migration risk together with the factors that could lead to an upgrade or downgrade.*"

Para 3.5-b. should only cover cases in which a CRA has decided to use a separate scale for structured finance product. We do not see any necessity for a CRA to explain why it does not use a separate scale and therefore recommend deleting "or not doing so" from the first sentence.

All in all, we have reservations about a separate rating scale for structured products. It is true that structured finance products, especially the junior tranches, have risk characteristics which differ from those associated with conventional corporate or covered bonds. On the other hand, however, the key way in which ratings make the financial markets more efficient is by enabling market participants to compare the probabilities of default and expected loss of different types of securities with different structures and origins. This benefit would be lost if an alternative rating scale were introduced for structured products.

Furthermore, a separate scale would only be acceptable if the term "structured finance product" were clearly defined. As explained above in the section on definitions, covered bonds such as Pfandbriefe should not be considered structured finance products. It is also important for the definition to be sufficiently precise to establish clarity while at the same time remaining flexible enough to accommodate new products. In the interests of consistency "structured finance product" should be defined not by each CRA individually but by a body whose definitions are universally recognised and applied.

With this in mind, we consider that it would be more appropriate to retain the present system and require CRAs to explain clearly and transparently in their reports and descriptions of methodologies the differences between various products in terms of risk structure and the stability of the ratings. The explanation could also include a summarising marker for these risk aspects. This would be more likely to make users aware of the different risk characteristics of different types of securities than would a separate rating scale, which would mix a long-term rating's basic message about the probability of default with an assessment of risk aspects.

In para 3.5-c. we suggest amending the first sentence as follows: "The CRA should *supply* investors *with all the information necessary to understand* what a credit rating …". What investors require is not assistance but adequate information about the most important characteristics of the ratings of various types of investment. It is then up to them to make the necessary decisions.

All in all, we do not consider the disclosure requirements proposed in para 3.5 to be sufficient. Our members believe there is a particular need for information about the stability of ratings. When rating structured finance products, CRAs should provide concrete details of the assumptions used to calculate probabilities of default, the assumed correlations between the elements of any secured portfolios, the stress tests used in the structural analyses and the consequences of different scenarios for the rating.

CRAs should also make clear under which circumstances a change in methodology will result in adjustments to ratings of new issues only and when rating reviews of existing securities are considered necessary.

The addition to para 3.8 is a step in the right direction, in our view. However, we are in favour of publicly accessible, regular and standardised studies on rating results and migration being published by all CRAs. Such studies are an important consideration in an issuer's decision as to which agency to mandate. We do not share the concern expressed by CRAs that standardised analyses will inevitably lead to a standardised rating methodology and therefore suggest amending the first sentence as follows: "In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should periodically publish *detailed* information about the historical default rates …". The final sentence should read as follows: "…standardized in such a way to *allow* investors *to draw* performance comparisons."

We recommend making the following addition (in italics) to para 4.3: "A CRA should publish in a prominent position on its home webpage links to (1) the CRA's code of conduct; (2) a description of the methodologies it uses *and an indication about the last update (date and changes made); as well as* (3) information about the CRA's historic performance data."