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5. August 2004



Re: Response to CESR Call for Evidence on Possible Measures Concerning Credit Rating Agencies

Dear Mr Demarigny,

The Bond Market Association (the "Association")<sup>1</sup> welcomes this opportunity to respond to CESR's call for evidence on Possible Measures Concerning Credit rating Agencies ("CRAs")

The Association has been and continues to be an active participant in some of the US initiatives referred to in the Annex to this Call for Evidence<sup>2</sup>. Most of the comments made by the Association in response to the SEC's concept release on rating agencies cover and are equally applicable to the issues raised in this Call for Evidence. We refer you to that letter for a discussion of our views.

CRAs play an important role in the fixed income markets by providing investors and other market participants with an independent source of information on the relative creditworthiness of fixed income instruments. We believe that their role will become increasingly important as the Basel II capital regime and the EU's Capital Adequacy Directive are fully implemented. Nevertheless, we do not believe that regulators should have unrealistic expectations about rating agencies. Rating agencies cannot reasonably be charged with uncovering all possible undisclosed risks or liabilities that might affect credit quality, or with uncovering fraud, embezzlement or other misconduct by issuers. Ratings agencies, like other market participants, must be able to rely on the integrity of the audit process to produce financial information that is accurate and complete.

In this letter, we will address several areas highlighted in CESR's Call for Evidence, which we have grouped under the following headings: (1) conflicts of interest, (2) transparency and consistency of rating methodologies, (3) barriers to entry affecting new competitors, and (4) appropriate level of regulatory oversight of CRAs.

#### Conflicts of Interest

The Association recognises that potential conflicts of interest between rating agencies, the issuers they rate and the users of ratings may exist. As a result, it is appropriate to

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<sup>1</sup> The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities internationally. More information about the BMA and its members and activities is available on its website [www.bondmarkets.com](http://www.bondmarkets.com).

<sup>2</sup> See BMA's responses to SEC's June 2003 Concept Paper on Rating Agencies and the Use of Credit Ratings, available on the SEC's website at <http://www.sec.gov/rules/concept/s71203/bondmarket072803.htm>.

require that a CRA have policies and procedures to address potential conflicts of interest, including potential issuer and subscriber influence. We also believe that laws relating to access by CRAs to inside information from issuers should be harmonised, and that CRAs should have robust policies and procedures for ensuring that material nonpublic information is not inadvertently disseminated, selectively disclosed or otherwise misused.

Nonetheless, the Association believes that CESR should not mandate specific approaches or methods for addressing conflicts of interests, such as firewalls, compensation structures, or revenue or asset limitations or other restrictions on certain non-rating activities, such as advisory services. Such services in particular are beneficial to many issuers and market participants, and the Association is aware of no evidence that such services present a significant conflict of interest warranting restriction. Within the general requirement that a CRA maintain appropriate policies to address conflicts of interests, CRAs should have flexibility in determining the appropriate policies and procedures, in light of the particular characteristics of their business and operations. This principles-based approach would also help facilitate entry of new rating agencies, as procedures appropriate for large, broad-based rating agencies may not be suited to newer agencies or agencies rating in only limited sectors or jurisdictions.

Rating agency reports are to a large extent analogous to fixed income research reports published by the research analysts employed by investment banks. As you may be aware, the Association has recently published guiding principles for fixed income research prepared by sell-side research analysts (the “Guiding Principles”)<sup>3</sup> in order to help our member firms develop policies and procedures for management of potential conflicts. Although the Guiding Principles do not by their terms apply to CRAs, the Association believes that a number of the general principles set forth in the Guiding Principles are equally relevant to CRAs.

We believe that the single most important factor in ensuring the integrity of credit research, whether performed by analysts at sell-side firms or CRAs, is vigilantly guarding the independence of those analysts from conflicts of interest arising from their personal life (such as personal investments), from their firms’ activities (such as interests in investment banking or consulting businesses) or from the interests of third parties (such as issuers).

The principle of independence is evident in a number of the Guiding Principles that we believe would be equally relevant to CRAs. In particular:

- Firms should promote the integrity of fixed income research and the ability of fixed income research analysts to express their own independent views.<sup>4</sup>

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<sup>3</sup> See See “Guiding Principles to Promote the Integrity of Fixed Income Research, A Global Approach to Managing Potential Conflicts of Interest,” which is available at TBMA’s website, [http://www.bondmarkets.com/Market/Guiding\\_Principles\\_for\\_Research.pdf](http://www.bondmarkets.com/Market/Guiding_Principles_for_Research.pdf).

<sup>4</sup> Guiding Principle 4.1.

- Firms should take measures to prevent inappropriate influence by non-research department personnel and issuers over the content of fixed income research reports and the timing of their publication.<sup>5</sup> In particular, firms should develop appropriate policies and procedures to control access to, and review of, draft fixed income research reports in order to promote the integrity of fixed income research.
- Firms should not permit issuers to review draft fixed income research reports before publication other than for the purpose of verifying the factual accuracy of information in the reports . . . . [I]f a research report contains an investment conclusion, this information should be removed from the draft report that is provided to the issuer.<sup>6</sup>

A number of questions in Section 3.3.2 CESR's Call for Evidence regarding the relationship between issuers and rating agencies implicate the independence (or perception of independence) of rating agencies. They assume that the issuer should have the opportunity to discuss with the rating agency the assumptions and fundamental determinants of their ratings and should have a role in the process of publishing information about the issuer, and that a CRA should archive "all information related to a rating" so that a rating decision can be explained to the issuer at a later stage. We believe that such access before the publication of a rating (and the potential it may provide for interference in the rating process) may undercut the public perception of the independence of CRA analysts. The U.S. equity research rules and the Association's Guiding Principles prohibit an analyst from sharing the conclusion of a research report with the issuer before publication (although the text of the report without the conclusion may be shared so that the issuer may ensure factual accuracy). If CESR plans to recommend that CRAs share rating report with the issuer prior to publication, we believe it should limit the requirement to factual information and make clear that the issuer is expected only to correct factual inaccuracies and move any non-public information, but not to challenge the opinions of the rating analyst.

### Transparency and Consistency

In order to ensure that issuers, underwriters and investors all understand the meaning of ratings, it is important that CRAs publish sufficient information about their rating methodologies, that issuers and underwriters understand how to structure their transactions in a cost-efficient manner to obtain the desired rating, that they are able to do so on the basis of clear ratings fee structure, and that investors understand the criteria used to assign ratings. See, e.g. IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies (25 September 2003), Principle 3.3. This goal is not always being met by major rating agencies. For example, over the last year or so, a series of unannounced new requirements have been imposed on investment firms by some or all CRAs in connection with structured finance transactions. These new requirements concern, among other things, withholding tax opinions (eg, on swap

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<sup>5</sup> Guiding Principle 4.3.

<sup>6</sup> Guiding Principle 4.3.3.

counterparty payments, and/or on the jurisdiction of each underlying collateral asset issuer) and certain security arrangements (eg, Belgian Law pledges, Slavenburg registration, defensive floating charges). Although we do not believe that regulators should tell CRAs how to rate securities, and we acknowledge the importance of allowing CRAs to alter their views of what protections are required to warrant a particular rating, we believe that general principles for rating agencies should be established that receive government recognition, and that rating criteria and amendments to rating criteria should be published and applied equally to similarly situated transactions.

Regarding Section 3.2., while we believe it is important for CRAs to disclose their rating methodologies, we do not believe regulators should regulate the rating methodology of CRAs. We will leave it to the CRAs to make the argument against prior restraints of the expression of what are essentially opinions about creditworthiness. We believe there a number of other reasons why regulation of rating methodologies is not in the best interest of issuers or investors. First, there are a variety of subjective factors about the management of an issuer that are crucial to the rating process. Such factors are not conducive to quantification by a regulator. Furthermore, the users of ratings benefit from seeing differing analyses of the same issuer, which might be less likely to occur if the regulators have mandated a particular methodology. Moreover, in the fixed income area, there is a substantial amount of innovation in terms of new products and variations on existing products. If a CRA could not rate a new product until a regulator approved a rating methodology for the product, it might add a substantial amount of time to the rating process, and windows of opportunity created by a particular interest rate environment might be lost.

In addition, we do not believe it is useful, and may indeed be misleading, for CRAs to disclose the “skills” of their staff. Indeed, we believe that calls by corporate treasurers for publication of the qualification and experience of the analysts assigned to an issuer may be designed to allow the rated company to challenge a rating based on the qualifications of a single analyst. It is our understanding that the ratings process at the major CRAs is a collaborative process. Thus, a rating is not the product of a single analyst, but of a committee. In our opinion, the best way to determine whether ratings are of high quality is through “back-testing”, i.e. determining after-the-fact the accuracy of the rating and whether the rating was consistent with the views of other CRAs.

Finally, a CRA’s new and existing requirements are not always consistently applied within the same CRA. For example, in the same CRA, several firms have seen three different approaches to a single issue, depending on the analyst involved. We believe that part of the requirement of transparency is that CRAs must apply their ratings criteria consistently. This means that CRAs must develop policies and procedures, including training and supervision, to ensure that their criteria are consistently applied.

#### Barriers to Entry

We are aware that certain market participants believe that the small number of recognised rating agencies gives too much power to those rating agencies. Nevertheless, we believe that ratings issued by the major CRAs have generally proved to be a reliable source of information for the fixed income markets. Consequently, we believe that the solution to perceived imbalances is not to impose substantial new regulation on existing rating agencies, but to encourage entry of new rating agencies while at the same time ensuring that the new entrants have the required capital and personnel to produce accurate ratings. See, e.g. IOSCO Principle 1.4 (CRAs should have sufficient resources to carry out high-quality credit assessments.) In particular, we support recognising CRAs that specialise in narrow segments of the market, as a way to increase the number of authorised rating agencies and to give more CRAs a base from which to grow. We are not convinced that regulators should ensure a level playing field between credit rating agencies by requiring that an issuer engages in discussions with one rating agency; it must give equal access to all CRAs. We generally favour market driven approaches to CRAs. This means that regulators should not impose unnecessary barriers to entry, and neither should they intrude unnecessarily into economic decisions made by market participants. If an issuer decides it is not in its best interest to provide information to a particular CRA, regulators should appropriately require disclosure that the CRA's rating reports are based solely on publicly available information. It should not, however, force the issuer to speak with the CRA.

#### Level of regulatory oversight

In assessing the appropriate level of regulatory oversight of CRAs, it is useful to consider the critical role that credit rating agencies have long played in the efficient functioning of the fixed income markets. Unlike certain factors that affect the value of a credit instrument, such as maturity, yield, call features and priority vis-à-vis other classes of creditors, issuer creditworthiness inherently cannot be measured with precision. Many of the factors that relate to a determination of issuer creditworthiness, including the capability and experience of management, the quality of risk controls, and the ability to adapt to changing market conditions, among others, require a significant degree of subjective assessment. CRAs, by aggregating factors, both objective and subjective, that form a part of credit standing give market participants an additional source of information that can help to confirm market assessments of credit risk.

At the same time, it is important to appreciate that CRAs represent only one information source available to market participants about credit quality. Sell-side and buy-side firms that are active in the fixed income markets conduct their own intensive credit analyses for risk management purposes, including the maintenance of adequate capital, and for purposes of identifying pricing discrepancies in conducting their trading operations. Further, much information is available to the marketplace in the form of research conducted by securities and independent research firms. From the standpoint of major market participants, therefore, ratings do not substitute for the need to carefully monitor the credit of issuers as to which firms have substantial credit exposure, but instead form one part of the mix of information that they use in performing that function.

As noted above, ratings issued by the major CRAs have generally proved to be a reliable source of information for the fixed income markets. The reputational and commercial interests of the agencies provide a strong motivation to maintain the credibility of their ratings. Historically, a variety of studies have demonstrated a consistent and clear correlation between long-term corporate debt ratings and the probability of default.<sup>7</sup> There should not, however, be an expectation on the part of regulators or market participants that any rating agency, or ratings system, will act as a perfect evaluator of credit risk or quality. This is due to the complexity of evaluating the various objective and subjective factors that affect creditworthiness and reflecting them in a single symbolic rating.

In addition, CRAs should not and cannot be reasonably charged with uncovering and evaluating all possible undisclosed risks or liabilities that might affect credit quality, or with uncovering fraud or other misconduct by issuers. CRAs, like other market participants, must be able to rely on the integrity of the audit process to produce financial information that is accurate and complete. Although they may have access to certain information not contained in public disclosures of issuers, they lack the resources and expertise to conduct an independent audit of all the financial information produced by the issuers they rate and cannot be expected to police in any meaningful way the review conducted and decisions made by accounting professionals.

We note that the European Parliament resolution recommended inviting rating agencies to set up a voluntary industry body that would determine best practice, encourage training and provide a disputes and arbitration procedure for issuers and investors that feel aggrieved by the rating process. We would support a voluntary industry body that would encourage best practices and training, and provide a forum for issuers and users of ratings to discuss issues arising in the rating process. However, we believe an arbitration procedure that could result in a mandate for a rating agency to change its opinion is inconsistent with the subjective nature of the rating process. A forum for discussing issues that arise in the rating process, combined with back-testing, lowering barriers to entry and increased competition is the best way to ensure accurate ratings.

### Conclusion

CRAs play an important role in the fixed income markets by providing investors and other market participants with an independent source of information on the relative creditworthiness of fixed income instruments.

There are certain issues and improvements needed in the rating process; a large proportion, however, are of a bilateral commercial nature between firms and CRAs. The Association does not believe that regulation of CRAs is an appropriate or necessary step towards restoring investor confidence in the financial markets. In fact,

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<sup>7</sup> See generally Credit Ratings and Complementary Sources of Credit Quality Information, Basel Committee on Banking Supervision Working Papers (August 2000).

it is not clear to us what precise “market failures” the European Commission is asking CESR to remedy through its advice.

The purpose of any anticipated regulatory oversight should be limited to (1) setting general principles such as the need for CRAs to produce and manage conflict of interest, to disclose rating methodology that are consistently adhered to by analysts within the same agency and to have robust systems in place to prevent the dissemination of non-public information, and (2) lowering entry barriers to the market for the provision of credit ratings. In this respect, we would support the current principles-based Basel II eligibility criteria.

For the reasons explained above, regulators should not, however, seek to impose specific conflict of interest disclosure requirements or to regulate on acceptable rating methodology or appropriate staffing levels and qualifications.

In closing, the Association sincerely appreciates the opportunity to respond to this Call for Evidence and look forward to a continuing dialogue with CESR on the issues highlighted above. Please do not hesitate to contact the undersigned should you have any questions or wish to discuss any of the above in more details.

Yours sincerely,

Bertrand Huet-Delaherse

Vice-President

European Legal and Regulatory Counsel