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- European Association of Public Banks and Funding Agencies -

Brussels, 31 January 2005

EAPB Position on the CESR Consultation Paper "CESR's technical advice to the European Commission on possible measures concerning credit rating agencies (Ref: CESR/04-612b)

The European Association of Public Banks (EAPB) represents the interests of 17 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions with a combined balance sheet total of EUR 3,000 billion and over 170,000 employees, i.e. representing a European market share of approximately 15%.

The EAPB would like to thank CESR for the opportunity to comment on the above mentioned consultation paper. Prior to the comments on the consultation paper, the EAPB wants to welcome that the European Union – respectively CESR – is endeavouring to consult these important questions closely with the market participants. The EAPB would very much appreciate CESR considering these comments and taking them into account. To the questions contained in the consultation document we reply as follows:

I. Introduction

1. Do you agree with the definition of credit rating agencies? If not, please state your reasons.

We agree with the definition proposed by CESR.

2. Do you agree with the definition of credit ratings? If not, please state your reasons.

We agree with the definition.

3. Do you agree with the definition of unsolicited ratings? If not, please state your reasons.

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

In our opinion, in practice it is not always clear, by whom the initiative has ultimately been taken. Therefore we inspire CESR to render the definition more precisely. The part "where the initiative has not been taken by the issuer" could for example be replaced by "where the rating is not covered by a mandate".

4. Do you think that issuers should disclose rating triggers included in private financial contracts?

We believe that the use of rating triggers is in principle a matter for a private form of contract and therefore a disclosure should not be obligatory. In case of problems concerning the future solvency of issuers which affect third parties, the provisions of the Prospectus Directive apply.

5. Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.

We consider the increasing trend to make ratings the basis for legal standards – for example in the context of the proposed framework for capital requirements for banks – as problematic. Each individual case should henceforth be reviewed critically to ascertain whether other ways to achieve the goals exist. Otherwise there is the risk that the regulation of important fields of economic activity will be assigned to CRAs, which are not subject of state supervision.

II. Competitive Dimension: Registration and Barriers to Entry

1. Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?

The barriers to market entry for new competitors originate especially in the non-existing "track record". By the "track record" the CRA should be able to demonstrate that it has a adequate history of issuing ratings that correctly reflect the credit standing of companies or countries it has rated. Furthermore setting up an international operating CRA is exceedingly capital-intensive. The aim should anyway be that the entry of additional competitors on the rating market remain possible. At the same time it is to ensure that ratings are of the quality needed for a functioning capital market.

2. Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

From our point of view it is not clear how many SMEs really need an external credit rating. On the one hand the costs of a rating are often very high. On the other hand the question comes up whether there are sufficient benefits for the SME resulting from the rating. At this stage we see no need for regulators to ensure a wider market coverage with ratings.

III. Rules of Conduct Dimension

Interests and conflicts of interest

1. To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

CRAs should establish adequate policies to avoid conflicts of interest. The CRAs at least disclose potential conflicts of interest. Disclosure rules could for instance be based on the provisions of the Commission's Market Abuse Directive (2003/6/EC) and Implementing Directive (2003/125/EC). Disclosure of whether the policies and procedures have been applied in each credit rating would make sense as these policies and procedures are based on voluntary decisions by rating agencies. In such a case the market needs the information to be able to exercise adequate control.

2. Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process, it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?

In our judgement the provision of ancillary services creates a potential conflict of interests between the CRA and the issuer or other parties. A complete prohibition is going too far. It is imaginable that special rules produce relief.

3. Do you think that structured finance ratings give rise to specific conflicts of interest that should be addressed in CESR's advice to the Commission?

It has to be clarified what CESR subsumes by the term "structured finance rating". For this reason we can not comment this question at the moment.

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

4. To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

In principle we consider the fist alternative as preferable. Policies should in particular include a separation of ratings business from ancillary business in personnel, functional and physical terms. Disclosure in terms of the second alternative are meaningful if the internal policies and procedures are not based on binding legal provisions.

5. To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?

We do not think that individual remuneration of ratings by issuers is a pressing regulatory problem. To the best knowledge of the EAPB there are no cases in which the published rating is better than the actual risk situation of the rated company. More important is in our opinion an understandable fee scheme.

6. In order to deal with issues related to unsolicited ratings, to what extent do you agree that it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures with regard to issuing unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?

We believe that it has to be disclosed whether a rating is only based on public available information or whether it includes also internal information of the company. A rating only based on public available information contains the (high) risk of faultiness. On this account disclosure requirement for unsolicited ratings should at least be provided as set out under (ii).

7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?

We believe that conflicts of interest which credit rating agencies may face as a result of legal or financial links with other companies should at least be made subject to a disclosure requirement as set out under (ii). This applies e.g. to rated issuers who have shareholdings in CRAs and vice versa or if a CRA that belongs to a group rates an issuer who is an important business partner of the CRA itself or other parts of its group.

Fair Presentations

1. **To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?**

To ensure a high-quality of ratings, employees of CRAs must have appropriate qualifications. The employees must therefore have the knowledge of the particular national laws and regulations in the issuer's home country and consider these in their ratings.

2. **Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments?**

No.

3. **Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?**

Issuers and investors need comprehensive information on rating methodologies to be able to interprete ratings properly. Otherwise there is the danger that investors and issuers misinterpret ratings which could lead to unjustified market responses. CRAs should make clear which methodologies they have applied to assess individual circumstances substantially influencing a rating result and whether and to what extent these methodologies and procedures have changed in specific cases or in general compared with previous ratings. There is also the need to document the rating process to ensure that rating decisions can be understood and reviewed ex post.

4. **Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages**

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

that you consider and which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?

Regulation of CRA methodologies should at most be confined to general requirements. This can e.g. contain the requirements that rating methodologies should be systematic, precise and fact-based. Specification of a group of issuers, markets and types of products are also to mention in this context.

5. Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?

We endorse in this regard the guidelines of the IOSCO Code, indeed many of the provisions remain very general. At this point more clearness would be desirable.

It is also important that CRAs should be required to disclose changes in their rating methodologies and criteria to issuers and investors before they start to use the new methodologies. In addition issuers should have the right to comment the proposed changes to avoid potential mistakes in the rating. Otherwise it has to be ensured that the CRA decides finally by itself on methodologies and other criteria.

6. Do you believe that regulation should concern all aspects of CRA's methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by self-regulation?

In our judgement full disclosure of rating methodologies should in particular contain the definition of rating methodologies and criteria, the weighting of rating criteria and the quality of research data.

<u>Relationship between issuers and rating agencies</u>

1. Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?

The issue of access to inside information by credit rating agencies is in general addressed adequately by the IOSCO Code and the provisions of the Market Abuse Directive.

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

2. What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instruments?

To ensure that the information communicated to the capital market is understandable and not misleading, issuers should not be obliged to disclose an imminent rating change. While imminent rating changes are inside information for issuers themselves, they only really become inside information once the rating process has been completed and the rating report and the wording of the press release have been agreed between the issuer and the CRA. CRAs are then required to disclose the result immediately thereafter.

3. Do you consider that the requirements of the Market Abuse Directive in this area sufficiently address the risks that inside information might be disseminated, disclosed, or otherwise misused?

During the rating process CRAs receive a lot of confidential information from the issuer. This can be information subject to Article 1 of Directive 2003/6/EC (Market Abuse Directive). But it can also go beyond out of this information e.g. other industrial and trade secrets. For this reason it must be on the one hand ensured that CRAs handle all non-public information concerning issuers confidentially until issuers have approved its release and on the other hand CRAs should be required to disclose how they ensure the confidentiality of non-public information.

4. Are there any other issues concerning access to inside information which CESR should consider from the perspective of establishing a level playing field between CRAs?

No.

5. Are there any other issues concerning the Market Abuse Directive's provisions concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?

During the rating processes according to Article 6 (3) of the Market Abuse Directive CRAs have to keep a list of the persons who work for them and who have access to specific information. This list has to be sent to the competent authority on request. Issuers are therefore required to enter in the list they keep only the CRA but not all the employees of the CRA with access to inside information. It is, however, unclear what the procedure is if the CRA is based outside the European Union. It should be examined here which measures may be taken to ensure that European regulators can obtain the information they need to enable them to do their job.

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

6. Do you consider that it would be helpful to have a dedicated regime governing CRAs and their access to inside information?

In our view, a minimum standard to handle confidential information from issuers is necessary.

7. Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?

and

8. In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRA's opinion?

Prior to disclosure of a rating decision by a CRA, the issuer should be instructed of basic considerations and key information of the decision. The information is necessary to ensure that errors are avoided and important new information can still be included in the rating result. Therefore it is necessary that the issuer can appeal against the result within e.g. six days, can raise objections with regard to incorrect or incomplete data, methodological errors and comparable mistakes and can demand a review of the result. The aforesaid should not mean, that ratings could be negotiated.

9. Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?

In our opinion the provisions of the IOSCO Code and the Market Abuse Directive are sufficient to ensure that the information published by credit rating agencies is accurate.

10. Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?

We endorse a specific regulation requiring credit rating agencies to keep a record of their rating processes and the data supporting their credit opinions.

11. Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?

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European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

In our opinion the establishment of a rating agency data room is not necessary.

IV. Regulatory Options concerning Registration and Rules of Conduct for Credit Rating Agencies

1. Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:

- **A full registration/regulation regime based upon detailed criteria;**
- **A lighter registration/regulation regime essentially based upon the IOSCO Code;**
- **To assess compliance to IOSCO Code Fundamentals in a parallel process to CRD's recognition;**
- **A third party's certification or enforcement of the IOSCO Code;**
- **Relying upon rules covering only specific aspects of CRAs' activity;**
- **Monitoring the market developments.**

In principle we do not believe that a comprehensive regulatory system for credit rating agencies with detailed provisions is the best way to achieve the target. The recently adopted IOSCO Code of Conduct Fundamentals, however provide in our opinion a suitable approach. IOSCO believes that its code should be implemented on a self-regulatory basis but does not rule out further measures if this approach fails to work. CESR should basically follow this way.

2. Could you please indicate your preferred option and highlight pros and cons that you see with regard to each policy option?

As mentioned above EAPB in principal believes that at first option 5 is to favour. Nevertheless there should be the following restrictions. To begin with, issuers and investors must know which CRA follows all provisions of the IOSCO code. Secondly the provisions of the IOSCO Code should be applied by CRAs in their daily business. And thirdly, CESR should monitor the compliance of the provisions and decide to a later point in time whether the goals have been achieved

3. Do you think the IOSCO Code of Conduct is conducive to reducing or increasing competition?

In our opinion, the IOSCO Code will just have a limited impact on the level of competition in the rating market. Track record and high costs creates high barriers to market entry and competition.

European Association of Public Banks
- European Association of Public Banks and Funding Agencies -

4. Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?

We do not know of any other areas at present.

5. To what extent is a joint treatment of rating agencies by banking and securities regulators desirable?

We believe, if CRAs meet requirements comparable to the ones in the IOSCO Code, recognition by banking supervisors should be possible, e.g. within the framework of the new regulatory capital standards. This would help to avoid a doubel work by regulators and CRAs.

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