Mr. Fabrice Demarigny
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Committee of European Securities Regulators
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BG/CJ

AFG response to CESR's questionnaire on the day to day application of the IOSCO code by the Credit Rating Agencies

Dear Mr. Demarigny,

In response to your questionnaire please find below the Association Française de la Gestion Financière (AFG) answers on the subject at hand.

The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include management companies and investment companies. Some are entrepreneurial ones; others belong to French or foreign banking, insurance or asset management groups. AFG members are in charge of the management of over 2200 billion euros - making the French industry the leader in Europe for collective investment management in particular (with more than 20% of EU investment funds assets under management) and the second at global level after the US, in terms of financial management location (wherever the funds are domiciled). In the field of collective investment, our industry includes – beside UCITS – a significant part of products such as hedge funds, real estate funds and private equity funds. We are of course a member of the European Fund and Asset Management Association, EFAMA).

The following answers reflect the opinion of our member firms (management companies) which have accepted to contribute to the preparation of our response. Although the answer has duly been reviewed by our competent working groups and committees, it cannot be considered as a definite opinion of the French Management Industry as a whole for the future.

1. **Do you know of cases where the methodologies used by CRAs were not consistently applied or where changes in methodology were not clearly explained and disclosed?**

None has been reported to us by AFG members.

2. **Do you know of ratings based on inaccurate information or issued without the credit rating agency having taken into account all relevant information?**

Most of the time, issuers ask for and pay for rating. In this case, ratings are based at the same time on public and private information. Then, CRAs have an obligation of confidentiality vis-à-vis the issuers. So, it is difficult for our members to forge an opinion on this question. In any case it appears impossible to take into account all relevant information.

3.1 Do you consider the CRAs devote sufficient resources to assign high quality credit ratings?

Yes

3.2 Do you consider the CRAs devote sufficient resources to assign high quality credit ratings of structured finance instruments and to monitor them on an ongoing basis?

Our members believe the major CRAs do in general a good job in the initial rating process of structured finance deals, prior to and at issuance. However, they point out that they are not in a position and do not have the resources and/or process to check the resources allocated by CRAs to this area of their business.

One of our members underlines that the monitoring of Asset Backed Securities after the launch of the deal is made public to the investors by only one of the rating agencies: it is clearly not optimal.

4. **Do you consider that the period of time during which the rating decisions, the rating reports and the updates are publicly available is sufficient?**

An updated " in-depth" rating report would be welcome on a yearly basis since it is not the case today for all the issuers rated by the three main rating agencies.

5. **Is it always clear to you which are the critical elements underlying the rating decision (including updates)?**

No. For example, one of our members told us not to understand the critical elements which have underlined the successive multi-notch downgrades of the issuer Coca-Cola Erfrischungsgetranke by Moody's in 2003.

For ratings which are sollicited and paid by the issuers, issuers accept to give inside information to CRAs. Point 3 of article 6 of the directive 2003/6/CE leads CRAs not to disclose inside information obtained during meetings with the issuer top management as long as issuers do not disclose such information to the public. This is why it is very difficult for all

the users of ratings to have a clear understanding of all the critical elements underlying the rating decision. However, it is important to take into account the fact that rating is more or less influenced by inside information.
We however can note that the disclosure on triggers for upgrades or downgrades is more and more transparent and quantitative, which is going into the right direction.

6. Do you think the ongoing surveillance of CRAs on ratings, which can result in a rating action, is effective and timely?

This is not always true as such since:

- In some cases, we feel that rating agencies use inside information to react, before the market gets this information
- In other cases, on the contrary, as the evolution of credit quality would need a timely rating action, we indeed observe a delay in delivering these rating actions.

CRAs were criticized because of perceived slow responses in high profile cases such as Enron or Russia. In fact, when they intervene in a difficult context, the downgrade of a note or the simple setting under monitoring of the issuer increases the concern of the investors. Sometimes, when a rating trigger clause exists in the wording of loans/bonds term sheets which enables creditors to require for immediate refunding, a downgrade leads the company to a treasury and confidence crisis. Experience shows that it is difficult to face such crisis. CRA should not push an issuer to be into default. Vivendi Universal is a good illustration for problems linked to an important and fast downgrading.

Another concern is the sequence for the change in the rating of issuers. Information will be initially integrated in the stocks price, then in the forecasts of analysts and finally, in the opinion of the agencies. It thus clearly appears that the downgrade of a note is, in part, a response to information already integrated in the stocks price and the forecasts of the analysts. This is another explanation of slow responses rates in a rating action (especially in downgrading).

7. Have you ever experienced (or heard about) situations where CRA or its employees have given any assurance or guarantee of a particular rating prior to rating assessment?

None has been reported to us

8.1 Do you consider that the CRA disclose clearly in the rating decision whether
a) the rating was not initiated at the issuers request?
b) the issuer has not participated in the rating process?

There were many criticisms about CRAs when they published non-requested ratings, based only on public information. Indeed, in the USA one problem has been reported to us – although marginal and as far as we know disappearing: one of the biggest CRAs has been, as far as we know, subject to an investigation for unfair trade-practices. A very conservative non-requested rating could be sufficient to persuade issuers that they cannot conduct business without getting official, paid, ratings from CRAs. That is why non-requested ratings could be

a little bit more "conservatives" than the others. For this reason, the existence of such a disclosure is crucial for the industry.

Is the above mentioned disclosure valuable to you?

Yes

8.2 Do you know of cases where the ratings of the type mentioned above (a and b) had a lower degree of quality than others?

Yes one has been reported to us. In general, ratings based on public information are more conservative than other ratings (see point 8.1).

9. Have you ever experienced (or heard about) situations where the CRA has denied the issuer the opportunity to clarify any likely factual misperceptions or matters that the CRA should be aware of prior to issuing or revising the rating?

No.

10. Are you aware of cases where the rating decision was influenced by pressures from issuers or other parties?

No.

11.1 Do you consider that the CRAs have put in place adequate separations and firewalls between credit rating analysts and staff involved in other businesses (such as rating advisory, consulting, credit assessment, research)?

Our members point out that they are not in a position to check the quality and efficiency of the process or "firewalls" put in place by CRAs in order to avoid interaction between their various activities.

Obviously, CRAs' first business is to provide high quality ratings to markets and investors. Moreover, most of these CRAs use their "savoir faire" in order to provide, directly or through subsidiaries, additional services such as advisory services to their clients. Other types of activities have arisen within CRAs, such as – for one major CRA - the issuance of international securities identification numbers (ISINs) on US securities with the request by this CRA to European institutional investors to sign licence agreements for the use of such ISIN numbers when trading those US securities.
The Market Abuse Directive is applicable to all CRAs, including those which provide for other services than ratings. This Directive already prevents or require the disclosure of the possible conflicts of interests for those CRAs, which must set up rules to prevent or publish any information regarding such risks of conflict of interests: "*(…) the notations of credit which they publish are presented in an equitable way and that they mention in a suitable way their interests or conflicts of significant interests in connection with the aforementioned issuers or instruments to which refer their credit rating (…)*".

Moreover, the MiFiD is applicable to CRAs which provide for advisory services as a regular business. In this case, rules of conduct and organizational requirements contained in this Directive are applicable. These rules require an appropriate level of separation between the different activities and/or disclosure of the potential conflicts it might create.

In particular, the Market Abuse Directive and MiFiD provide for incentives to set up adequate firewalls between credit rating activities and other business.

However it would be useful for agencies to systematically mention in their analysis notes for a specific issuer all the services which they have carried out for this issuer during the last 12 months (as it is currently done by the analysts).

Some of our members highlight that, in many cases, there is one area where the separation is not effective: the top management. Sometimes, managers of subsidiary companies must directly report to a director who is in charge of the credit rating activity.
It would be an important step forward if a "Chinese Wall" could also be implemented between the organisational charts of the different entities.

11.2 Have you ever been in contact with credit rating analysts for other services than the one they provide within the context of credit rating?

No.

12. As an issuer, have you ever negotiated the fees of the rating services with analysts involved in the rating process?

Question not relevant to us.

13. Have you experienced any situation where the rating disclosure was not done in a timely manner?

None has been reported to us.

14. Have you encountered any problems in relation to the use of confidential information in your day –to-day business with the CRAs?

None has been reported to us.

15. Do you know of cases where the credit rating agencies are not applying the provisions of their own code of conduct?

No, but it is difficult to check.

16. Are there any other comments you would like to make?

The role of CRAs is particularly important for the proper functioning of financial markets. Ratings have become an essential precondition for corporates which want to issue bonds. Ratings determine at the same time the rate of the different issues and more and more the

evolution and fluctuation of the stock prices themselves. So, information provided by CRAs must be as timely relevant, fair and accurate as possible.

We would like to thank CESR for investigating in order to improve rating quality and market efficiency and we want to contribute to the debate on the concentration in the rating industry.

Indeed, beyond the improvement and the sophistication of techniques used by CRAs for rating decisions, it seems very important to increase the quality and the integrity of financial accounting. The consequence of any inadequate control is, indeed, the increase of liquidity risks.

On the one hand, a wider competition between CRAs could increase diversity of analysis, and may avoid some market failures. The impact of a particular rating may be lower if there are more than two or three CRAs providing analysis on one issuer. In this framework, competition is naturally essential. As far as there is also a barrier to entry into the CRAs market, this market is more an oligopoly than a perfect market. The current oligopoly in practice might generate the risk that CRAs use their weight on the market to maintain a high level of prices. Competition authorities, such as the EC, should monitor this situation.

On the other hand, it is also necessary to keep in mind that, whatever incentive measures will be taken to facilitate competition, the size of the bonds market, number of issuances, small market share of each issuer facing CRAs are elements which ensure a certain independence of the agencies vis-à-vis issuers. A wider fragmentation of this business might have harmful opposite effects such as leading credit agencies to give the best ratings in order to gain market shares. In other terms, the power they acquire through the oligopolistic situation is an 'antidote' to the agency problem linked to the fact they are paid by the firms they rate.

It must also be stressed that companies should reduce the asymmetry of information on the market by disclosing more widely "inside" information to the public, especially information concerning their indebtedness and strategic elements which may induce long term profits. Buy and Sell-side analysts could also increase credit analysis in their studies, and investors (such as insurance companies, banks with Basle II and Solvency II reforms) could develop more sophisticated internal models in order to quantify credit risk.

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If you wish to discuss the content of this answer with us, please contact myself at 00 33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), our Head of International Affairs Stéphane Janin at 00 33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or his deputy Catherine Jasserand at 00 33 1 44 94 96 58 (e-mail: c.jasserand@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon