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Subject: **Response to the CESR consultation on technical advice to the European Commission on possible measures concerning Credit Rating Agencies**

Dear Mr. Demarigny,

On behalf of the European Banking Federation (FBE), I am happy to attach our response on possible measures concerning credit rating agencies (CRAs). As arrangers, investors and issuers, banks are key users of ratings. We consider it vitally important that issues relating to credit rating agencies are treated appropriately and with due regard, above all, to the quality of ratings.

The FBE feels that the current debate on the activities of rating agencies has proved invaluable to all market participants in analysing the role that rating agencies play in global financial markets. However, as this consultation comes to an end, and having looked at all of the relevant factors, the FBE firmly believes that CRAs should not under any circumstances become regulated bodies.

Putting a regulatory framework in place for rating agencies would lend a legitimacy and credibility to ratings that, in our view, would be both inappropriate and dangerous. Credit rating is not a scientific process. Ratings are expert judgements based on both qualitative and quantitative analysis which results ultimately in the publication of an assessment by professionals on the probability of default of a certain issuer or certain papers. Ratings are, therefore, subject to change and can differ between different CRAs.

The views and behaviour of, not just the rating agencies, but investors, issuers, advisers and arrangers must be taken into account in any recommendations to the Commission. In that context, we commend CESR for the breadth of its consultation. While regulation by official bodies may have little impact on the actual behaviour of rating agencies, which rely heavily on validation from the market, it could impact on the behaviour or perception of ratings of other market participants. By formalising the credit rating process through legislative measures, the perceived role of ratings in the economy could be accentuated rather than curbed.

Taking these comments as a starting point the overarching principles in the attached FBE paper are the following:

- The correct framework for CRAs is self-regulation based on compliance with the IOSCO Code of Conduct Fundamentals with a strong emphasis on the principle of comply or explain and recognition that the Code must evolve to take account of market realities;

- There is no evidence at this time that there is a threat to the quality of ratings produced by CRAs. However, increased transparency and disclosure as provided for in the IOSCO Code would improve the relationship between CRAs and the market. Proprietary ability and knowledge should be respected in any disclosure regime;

- Compliance with the IOSCO Code should be the basis for recognition of ECAIs under the Basel Framework. Recognised ECAIs will have to be listed centrally under the proposed Supervisory Disclosure Regime in the Capital Requirements Directive. This listing should suffice as recognition of compliance with the IOSCO Code. It would be non-sensical to establish a separate registration system;

- The global nature of CRAs must be respected. A stricter regime in Europe would be detrimental to the interests of European public and private issuers and to the future development of European financial markets. Furthermore, CRAs must have total freedom of expression and must be independent from political or business influence.

Our detailed comments are attached (Enclosure 1). The FBE looks forward to seeing your final report to the Commission.

Yours sincerely,

Guido RAVOET

Enclosure: 1

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European Banking Federation

February 2005

FBE response to CESR's consultation paper on technical advice to the European Commission on possible measures concerning Credit Rating Agencies

I INTRODUCTION

1. As stated in the covering letter the FBE believes that this consultation has been useful in generating debate amongst market participants on the role of Credit Rating Agencies (CRAs) in the European economy. From the input which CESR has received and from the majority view expressed at the hearing in Paris on 14 January 2005, it is our view that there is no evidence at this time that there is a need for legislation in this area beyond that already in the CRD and being developed by CEBS on the recognition of ECAIs. We also do not believe that a registration system would add value. Our reasoning behind this position is elaborated below.

2. It was the view of the European Commission's expert groups on integration of the European markets that legislation should, in future, be necessity driven with clear cost/benefit analysis. The FBE welcomes the depth of CESR's consultation on this issue and its willingness to recognise the voice of industry. In that context, we would urge CESR in its advice, as well as the European Commission and the co-legislators, not to move closer to legislation in this area on the basis of political momentum. Any move to create a regulatory framework for CRAs, given the overwhelming view from market participants that it is not necessary, must be carefully justified.

3. The FBE believes that the focus of the consultation and of CESR's analytical report to the Commission must be the quality of credit rating in Europe. While accepting that there is a restricted number of globally active CRAs, we feel that the consultation paper puts an excessive emphasis on the barriers to entry into the industry . We do not believe that there is any evidence that the specific structure of the ratings industry has impacted on the quality of ratings.

4. Although ratings are, and should be, the result of high quality research done by professionals with appropriate knowledge, the rating process is not an exact science and ultimately CRAs produce expert judgements or opinions which are then used, amongst other information and research, by investors. Ratings change according to market conditions and cannot therefore be taken as absolute truth. The emphasis in the rating process should be on appropriate analysis of the correct quantitative and qualitative information and on a high level of disclosure of how the CRA has arrived at the specific rating.

5. It is important to take account of the impact any measures may have on investors, issuers and the efficiency of markets. In this context, the views of

the European banking industry reflect our role as issuers, investors, arrangers, advisers, trustees, etc. The FBE has also looked at CESR's consultation in the context of banks' internal rating mechanisms and the possible implications for banks in the long run.

6. The Consultation Paper refers to cooperation between CESR and CEBS regarding the Capital Requirements Directive. This cooperation is of utmost importance to industry. It is our belief that any action taken regarding CRAs should be limited to within the CRD framework. Therefore, the reports of the two Level 3 Committees must be consistent. ECAIs recognised in Europe should be of the same minimum quality as those recognised under the Basel Framework and must be compliant with the IOSCO Code Fundamentals. Furthermore, the conditions developed by CEBS on the recognition of ECAIs should be applied consistently by supervisors to ensure a level playing field for CRAs active in Europe.

II Global Approach

7. The FBE welcomes the recognition in the Consultation Paper that Credit Rating Agencies (CRAs) operate in an international environment. In this context, the IOSCO Code Fundamentals are an appropriate basis for self-regulation in the EU.

8. In addition, the United States Securities and Exchange Commission (SEC) is expected to release recommendations in the New Year which will address the Nationally Recognised Statistical Rating Organisations (NRSRO) status. The SEC is expected to publish the findings of its public consultation in the New Year. While the IOSCO Code Fundamentals are key to developing a framework within the EU, it is also important for CESR to take account of any action taken in other jurisdictions. European financial markets must not become less attractive to any market participants as a result of over-prescriptive measures. At the same time we would not recommend moving towards a US-style recognition system.

III Definitions

9. The FBE broadly agrees with the definitions as set out in the consultation paper. However, the second bullet point of paragraph 26 on the definition of a CRA could be misinterpreted to include Internal Ratings of banks for Pillar 1 of the CRD.

10. With respect to the definition of unsolicited ratings, we suggest replacing the phrase "where the initiative has not been taken by the issuer" by "where the rating is not covered by a mandate". It is not always absolutely clear in practice who took the original initiative. Moreover, only a rating that is covered by a mandate is likely to be based on the comprehensive information normally required for ratings.

11. We do not have a view on whether the distinctions between unsolicited ratings should be covered by clear definitions or whether they should be addressed through disclosures made with the rating. In either case, account

should be taken of whether or not there has been payment, whether or not the issuer has willingly cooperated with the CRA and whether or not confidential information has been used or the rating has been based on public information. We also feel that unsolicited ratings should be flagged as second rate ratings under all circumstances.

IV Use of ratings in private contracts in Europe

12. The FBE continues to believe that the use of ratings in private contracts is a purely contractual matter and should, therefore, not be regulated. The question of rating triggers is of particular significance to banks. We agree that on the capital markets it should be the issuer who discloses the nature of the rating trigger to the market. Any requirement for banks to do so would be in breach of customer confidentiality. We, therefore, agree that the issue of rating triggers is covered by the provisions in the Prospectus Directive.

V Use of ratings in European legislation

13. As stated in our response to the Call for Evidence, the FBE does not believe that the use of ratings should become prevalent in EU legislation. This should be judged on a case by case basis and alternatives should be sought to keep the entry barriers to EU markets as low as possible.

VI Competitive Dimension: Registrations and barriers to entry

14. The FBE agrees that there is a restricted number of globally active CRAs. However, we would stress that the focus of any advice to the Commission must be on the quality of the ratings and on the efficiency of financial markets, but not on the mechanisms needed to break down what could be regarded as natural barriers to entry into the ratings market. There is growing competition between the three big rating agencies. They do not use the same rating methodologies. They work in an increasingly demanding environment in terms of customer service demands and market conditions. Most importantly there is no evidence that the main agencies are not producing high quality ratings.

15. The FBE does, however, agree that it would be in line with the EU's objectives to ensure that any unnatural barriers to entry are removed and that a framework exists in Europe which allows small players to be successful. We believe that regulation by public authorities would be a significant barrier to entry for small players in terms of compliance costs. Given that the small players in Europe will be seeking to be recognised under the CEBS ECAI recognition regime, we do not feel that there would be any value in forcing them to comply with another set of rules. Recognition under the CRD should be the benchmark by which investors judge the trustworthiness of a rating agency.

Natural barriers to market entry or expansion

16. The Consultation Paper provides a full and accurate view of the barriers to entry that exist in the ratings industry.

17. The specific barriers to entry in the ratings industry are typical of any industry which relies heavily on reputation and experience. It is possible that smaller CRAs may become active under the Basel Framework in the context of rating SMEs or specific sectors. However, this will be determined by the market and should not in any way be regulated other than to ensure they are of a sufficiently high standard through compliance with the IOSCO Code of Conduct Fundamentals. Again, the quality of the ratings themselves should be viewed as the most important objective.

18. As the consultation paper suggests, unsolicited ratings may provide a means of entry to the market for new CRAs. The FBE agrees that where a rating is unsolicited this should be disclosed. We also believe that unsolicited ratings should be categorised depending on the nature of the relationship between the rating agency and the issuer. This relationship should be disclosed along with the rating and the details of the process used in that rating. Furthermore unsolicited ratings should be viewed as second rate and this should be explicitly stated where they are published.

Registration and entry barriers

19. The FBE firmly believes that proper conduct, correctness and transparency by CRAs can be delivered through self-regulation in the form of a Code of Conduct based on the IOSCO fundamentals. The Code of Conduct should ensure that the level of disclosure required of the agency will allow full transparency of practices to the market. Transparency is the key to market participants understanding the role of rating agencies and therefore determining their reliability.

20. Given that the FBE does not believe that a regulatory framework should be put in place for CRAs, it follows that we also do not believe that a registration system is required in the EU. Under the Supervisory Disclosure regime in the CRD, CEBS will have a centrally accessible list of ECAIs recognised by Member States according to the recognition criteria. We feel that any CRA of sufficiently high standard will want to be recognised as an ECAI and there is, therefore, no reason to duplicate this listing system. The Consultation Paper asserts that a registration system would allow smaller CRAs to break into the market. We argue that it would be sufficient for those smaller CRAs to state that they are a recognised ECAI under the CRD requirements.

21. In this context the FBE urges CESR to continue its close cooperation with CEBS to ensure that any specific concerns CESR may convey to the Commission are adequately dealt with through the work of CEBS on ECAIs where possible. In our view many of the issues which are covered in the Consultation Paper will form part of the ECAI recognition criteria.

22. The FBE does not perceive any lack of coverage regarding SMEs or specific segments. It is beyond doubt that CRAs will grow in importance in the EU as more medium sized companies seek funding on the financial markets. However, this will be a natural evolution and any attempt to regulate the

boundary between financial markets and banking markets would interfere with the development of EU markets. Furthermore, this evolution will most likely provide more opportunities for smaller CRAs to grow their market share.

VII Rules of Conduct Dimension

Interests and conflicts of interest

23. The FBE agrees that there are conflicts of interest within CRAs but does not believe that these conflicts are markedly different than those faced by other market participants. Conflicts of interest should be dealt with through a mixture of disclosure and Chinese Walls where possible as set out in the IOSCO Code Fundamentals. Essentially the FBE agrees that Chinese Walls should be used where possible. Where it is not possible for operational or other reasons to separate two business units, then the reason why this is not possible should be disclosed with the policies and mechanisms in place to prevent conflicts of interest.

24. A distinction must be made between consultancy services carrying out entirely separate work and the ratings advisory or analyst services. It is clear that in the case of separate services provided by the rating agencies, Chinese Walls provide an appropriate means of dealing with the conflict of interest.

25. However, it would be impossible for CRAs to put Chinese Walls in place between the rating advisory and rating analyst services or indeed between those services advising on structured finance. While, in theory, Chinese Walls may seem like the appropriate way to deal with the conflict of interest between staff working in advisory and analytical roles, the reality is that rating agencies are limited in the number of staff they can recruit and Chinese Walls therefore prevent efficiency in their operations. While the FBE has some sympathy with these arguments, we do, however, believe that the conflict of interest must be fully disclosed. In this context we welcome the IOSCO Code's emphasis on disclosure.

26. We do not agree that CRAs should in any way be restricted from carrying out ancillary business with a rated entity. Disclosure is the right way to deal with the conflicts of interest in combination with separation of management, staff and robust Chinese Walls. Ultimately the market will determine whether or not the credit rating is the correct reflection of the credit worthiness of the issuer and it is, therefore, not in a CRAs interest to allow other relationships to influence the rating process. As discussed earlier in the paper, CRAs depend largely on reputation to sustain their business and will, therefore, not knowingly jeopardise that reputation.

27. Furthermore, the possibility of providing ancillary services also provides further opportunities for new entrants to enter the ratings industry and successfully gain market share.

28. The FBE does not see any special conflicts of interest arising from structured finance products.

29. The FBE does not necessarily agree that there is a necessity for compliance with published policies and procedures to be disclosed with each individual credit rating. We would, however, agree that in the case of monitoring of existing ratings that the CRA should indeed confirm in each case that it has complied with due process. It is possible that the monitoring of existing ratings could be inferior to new rating procedures as a result of staff turnover, lack of payment and the complexity of deals.

30. CRAs are private entities and as such decide pricing on the basis of a number of factors. It is not clear to us that the creation of a fee scheme would prevent the issuer from influencing its rating and in fact this fee scheme would introduce yet another barrier to entry for smaller players. Again, we reiterate that the reputation of a CRA, based on independence and objectivity, is the basis of its business. In our view it is unlikely that a CRA would be influenced by the fee which it is receiving. In addition, if such attempts to influence were commonplace, means by which to influence other than fees would be found.

31. We do not believe that it is in the interests of CRAs to allow ratings to be influenced by their relationships with issuers. This influence would impact on their reputation in the markets. We do, however, agree that where such a relationship exists that it would be appropriate to disclose its nature.

VIII Fair Presentation

Level of skills of agencies' staff

32. The FBE supports the IOSCO Code Fundamentals 1.4 and 1.7 regarding the quality of the rating process and believes that compliance with these points is sufficient to ensure that CRA employees are adequately trained to carry out their roles. If at the end of this consultation it is decided that a regulatory framework is indeed needed in Europe (which, we reiterate, we do not support) then we firmly believe that there should be no interference in the recruitment policies of CRAs but rather an emphasis on training.

Methodologies used for building credit ratings

33. Again the FBE believes that compliance with the IOSCO Code is sufficient in this regard. We do not necessarily believe that it is necessary to disclose compliance with published policies on staff levels with each rating except where this might be required by the legal system in a specific Member State.

34. Regarding alternative approaches to tackling the risk that staff are not properly trained, we believe that a CRA which did not employ a highly skilled rating team would not survive for long on the market due to the reliance on reputation. It is not in the interests of any commercial undertaking to employ staff not adequately qualified to carry out the work.

35. The question on whether undisclosed methodologies could lead to biased ratings is theoretical. Methodologies are currently disclosed by CRAs.

36. We do not see any advantages in the regulation of CRAs by securities regulators. Regulation of CRA's methodologies would erode both their independence and their competitive nature. We do not believe, therefore, that it would contribute to the objective of high quality ratings. The FBE believes it is sufficient for CRAs to disclose their methodologies to the market as far as possible without jeopardising proprietary information.

37. We believe that the IOSCO Code Fundamentals are sufficient in their recommendations on disclosure. We also agree that CRAs should disclose any change in methodology both to issuers and to the market at large before it becomes practice. Where CRAs are not compliant with the disclosure regime as set out in the IOSCO Code Fundamentals they should explain why.

IX Relationship between issuers and rating agencies

Access to inside information by rating agencies

38. The FBE believes that CESR's consultation paper accurately describes the scenarios in which CRAs might be the 'owners' of price sensitive information. The problem seems to be well-covered by the combination of the MAD and the IOSCO Code Fundamentals. We do not see a need for any further measures in this area.

39. The FBE does not believe that a system of arbitration would add value to the rating process. Differences of opinion between CRAs and issuers should be discussed between them solely. In limited circumstances, where the difference of opinion is felt to explicitly relate to objective errors and misjudgments, the issuer should be able to demand a review of the rating before it is published and only within a limited time frame. We feel that investors would be more at risk if a rating reflecting the wrong picture of an issuer's credit standing was published and subsequently revised, than if the final publication of the rating was slightly delayed in order to ensure its accuracy. A rating should, however, never be the result of negotiations. In cases where the difference of opinion cannot be resolved quickly, the market must be allowed to determine the accuracy of a rating. It is not after all, as recognized in the MAD, an investment recommendation. Therefore, we believe that where an issuer wishes to contest a rating this information should be disclosed to the market with the rating itself.

40. The FBE agrees that data relevant to ratings should be kept for a minimum period of 5 years and for longer where a rating continues to be monitored. However, as we do not believe that there should be a separate regulatory regime to the one which will be developed by CEBS for the purposes of the CRD, we would recommend that this provision be one of the criteria for ECAI recognition.

X Regulatory options concerning registration and rules of conduct for credit rating agencies.

41. In conclusion, the FBE does not believe that it is appropriate at this time to put a regulatory framework in place for CRAs. Firstly there is no evidence that there is a need for CRAs to be regulated or that this would in fact help new entrants to become active in the ratings industry. Secondly there would be a danger in allowing CRAs to become licensed or regulated bodies in that this could impact on the perception of ratings amongst investors. In this context the FBE's conclusions would be the following:

    - There is no need for regulation. Self-regulation based on the IOSCO Code of Conduct and "comply or explain" is the correct and appropriate conclusion in our view;

    - CESR's report to the Commission should take close account of the work of CEBS. The FBE believes that the framework for the recognition of ECAIs, which should also use the IOSCO Code as a basis, is sufficient for ensuring that CRAs active in the EU whether in the banking market or financial markets, are compliant with the IOSCO Code;

    - The quality and reliability of CRAs ratings will, and should, be determined by the market.