



CESR CONSULTATION PAPER: THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE. FEBRUARY 2008

The ABI's Response

Introduction

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

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.

General Comments

We note that a number of reports on the role of credit rating agencies are expected shortly, including IOSCO, ESME and CESR.

Events since mid 2007 have intensified the debate on CRAs within the institutional investor community. Some have questioned whether CRAs, as commercially-driven entities, can meet the expectations placed on them by the market and whether fear of reputational loss is a sufficient incentive to good governance. Questions have also been raised about whether CRA activity is unhealthily pro-cyclical and about their changing business model both with regard to the dominance of structured finance business and the ancillary business as credit research firms publishing paid-for research.

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, but we remain opposed to general regulatory intervention.

Our members consider that CRA ratings are only one of several inputs into the investment decision-making process. Indeed a number of ABI members have their own in-house analytical resources, which provide the equivalent of ratings from CRAs. Consequently we are concerned that some observers, including regulators, may attribute a greater general importance to CRA activity for investors than reality actually merits. Institutional investors are will aware of the limitations of the current regime.

The key requirement for 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, may derive greater benefit from ensuring the availability of this larger information universe than concentrating on merely one aspect. 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 CRAs would provide benefits to investors.

Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?

Yes. This is essential on at least two counts, first because of the greater technical complexity of products in structured finance and second because globalisation has broadened the investor base beyond traditional institutions. It is essential that this broader, more disparate investor base has the appropriate information for investment decision-making and for preventing the development of misconceptions as to the content of ratings.

We note (paragraph 77) the assertion that investors became over-reliant on ratings. We find this troubling as, though frequently made, little evidence is provided to substantiate it. To reemphasise our members regard ratings as only one input into their decision-making.

Do you agree with CESR's views that although there has been improvement in transparency of methodologies, the accessibility and content of this information for complex structured finance products requires further improvement needed for them to judge the impact of market disruption on the volatility of the ratings?

Yes. In particular our members have noted that information on the sensitivity of input data would allow them to make their own assessment of changing market circumstances.

With reference to CESR's comments in paragraphs 85-89, with which we broadly agree, and on the costs of additional information, we note our comment to CESR's questionnaire (CESR/07-394 B Q.1) and repeat the relevant section below.

"Despite the ready availability of ratings on a case-by-case basis, our members are nevertheless concerned that they are required to subscribe to additional high-cost services to receive full transmission of rating information. This disadvantages smaller investors in a manner that is incompatible with the "public good" nature of credit ratings. For example;

- a) Only subscribers to each CRA's paid for website can utilise automatic email facilities that "push#" emails to subscribers immediately ratings actions are announced (and/or research is published)
- b) Bulk dissemination of ratings and rating actions is only available to investors who pay rating agencies substantial license fees to

download up-to-date ratings data files (directly or via Bloomberg) into real-time portfolio management systems.

Concerns about the cost burden on investors arising from these developments in CRA's business models, that particularly disadvantage smaller investors, increase if the number of CRA's active in the market increases.

CRA's business models have developed from that of credit assessment firms assigning ratings to credit research firms publishing research. Our members have indicated that whilst structured finance ratings and rating methodologies are now better communicated by the CRAs, on-going research on specific transactions is only available to investors and other market participants who subscribe to their research services. This is highly unsatisfactory for structured finance instruments given that issuers are generally unlisted special purpose companies that may not be obliged to provide full disclosure of their financial statements to the market on an on-going basis."

Do you agree that there needs to be greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as ratings reviews?

Yes, particularly when bearing in mind the changes in methodology that CRAs have introduced since mid 2007. Investors must be appropriately informed as to the degree of comparability between historic and current information provided to them.

Do you agree that there needs to be greater public and standardised information on structured products in the EU? How would this best be achieved?

Greater transparency and standardised content in information should be encouraged. Standardisation aids comprehension but it should not be carried to such lengths that it inhibits innovation and the development of products better suited to the market. Market participants, individually and through their trade associations, are re-assessing best practice in the light of recent market turmoil.

We believe that this market-based activity is the most likely action to produce the required changes in the shortest practical time. Indications are that standardisation will be at regional level e.g. EU, given the legacy nature of activity in various parts of the global markets.

Do you agree with CESR that contractually set public announcements on structured finance performance would not add sufficient value to the market to justify the cost and possible saturation of the market with non-material information.

Yes. But this is not to deny the need for improvement in monitoring. Our members have expressed concern as to the timelines of periodic reviews particularly in the case of CDOs.

In the case of (UK) PPP and PFI projects there is a paucity of information on the relevant assets' performance post the initial ratings. These deficiencies have been highlighted by developments since mid 2007 where there has been a dramatic

deterioration/downgrade of certain AAA monoclone insurers and are now generally recognised.

Where there has been a dramatic deterioration/downgrade of certain AAA monoclone insurers, do you agree that the monitoring of structured finance products presents significant challenges, and therefore should be a specific area of oversight going forward? Are there any particular steps that CRAs should take to ensure the timely monitoring of complex transactions?

Yes monitoring is an issue. Moreover the CRAs commercial reaction to anticipated lower activity in structured finance, a marked reduction in staffing levels, is not reassuring from the viewpoint of spikes in activity (para 106). See also our response above to para 104. We would agree with an updating to the IOSCO Code, which highlights the need to allocate sufficient resources to this area.

Do you believe that the CRA's have maintained sufficient human resources, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business?

Any assessment here is highly judgmental. Developments since mid 2007 have highlighted that CRAs need to improve performance significantly in certain areas. However, they have not been the only market participants found wanting.

Until recently there was intense competition within the financial services sector overall for appropriately qualified personnel. The CRAs were not immune from this pressure and required appropriate recruitment and training policies to cater for the situation, which would be expected to demonstrate some cyclical attributes. CRA employees ought to be employed under employment contracts that have lengthy notice periods given they, like regulators, occupy such a privileged position in the debt capital markets.

The key issue is that CRAs are sufficiently resourced to provide consistent quality in their services.

Do you consider that the generally unaltered educational and professional requirements of CRA's recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

CRAs require an eclectic mix of human resources. One potential criticism of their resourcing policy in structured finance might be that they over concentrated on theoretical capacity to the neglect of commercial experience. To the extent that many now expect a reversion in the structured finance market to lower levels of activity and the simpler versions of the products, recruitment may pose less problem to CRAs (though possibly counterbalanced by reduction in experienced personnel – see above).

Do you agree there is a need for greater transparency in terms of CRA resourcing?

Yes. It will help in assessing the quality of CRA outputs.

Do you agree with CESR that more clarity and greater independence is required for analyst remuneration at the CRAs?

Yes. It will help to demonstrate that conflicts of interest are being managed.

Do you see the level of interaction between the CRAs and issuers of structured finance products creating additional conflicts of interest for the CRAs to those outlined above? Do you believe that any of these conflicts are not being managed properly?

We would agree with the CESR suggestion (para 123) that the IOSCO Code be updated. In this context our response to the CESR Questionnaire (Q15) bears repeating.

Q15 Are there any additional points you would like to raise, on the basis of your experience in the structured finance business?

“Our members have noted the inevitability of the tension between competition between CRAs for new rating assignments and the common good of the investor base overall. Disclosure and high standards of corporate governance are seen as the keys to managing this tension.

Our members have particular concerns about the tendency of CRA's not to take positive rating action in respect of a structured finance instruments if positive rating action would preclude further “tap” issues and block an issuer's access to the capital markets. Such an approach is likely to be contrary to CRA's own credit policy (credit decisions should be independent of the impact they might have on an issuer) and suggests that potential conflicts of interest are not being managed properly (rating upgrades do not generate rating fees whilst tap issues do)

In order to manage litigation risk for themselves and their clients, lead managers/issuers;

- No longer produce new issue research to support the sale of structured finance instrument
- Disclose as little information as possible in the Offering Memorandum (and include broadly based disclaimers)
- Limit the provision of useful information in the sales “pitch book”.

The effect of this is that CRAs have become perhaps the only source of detailed information to the market, yet the CRA's may not owe investors a duty of care when rating or reporting on structured finance instruments. Our members are concerned that the structured finance market is developing such that there is a lack of information they can “rely on” in the legal sense when making investment decisions. This is because lead managers are reducing information flow to manage their litigation risk and structured finance issuers are generally special purpose companies with no trading history, frequently domiciled offshore, that are not required to publish on-going financial statements. Our members do not believe it is for CRAs to fill the information gap despite the commercial advantages to CRAs in doing so. CRAs are increasingly demanding higher fees to access their internet

based research services and in order to do so they need to increase the breadth of coverage and include content that is indispensable to investors.”

As noted events since mid 2007 have highlighted the necessity for access to the underlying data on which structured products are based.

Do you agree that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers with regard to structured finance products and that there needs to be clearer definitions of acceptable practice?

See our response to the preceding question.

Do you believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core ratings business?

Yes. Note our previous comment on the trend for CRAs to offer paid for research services.

Do you believe that the fee model used for structured finance products creates a conflict of interest for the CRAs? If yes, is this conflict of interest being managed appropriately by the CRAs?

Experience indicates that a more transparent management of the conflicts of interest is required. The fee policy for structured finance has pushed the boundaries of conflict of interest so as to raise concerns that it has impaired the status of CRAs as ‘disinterested observers’. Greater demonstration of management of the conflict is required.

Do you agree with CESR that there needs to be greater disclosure of fee structures and practices with particular regard to structured finance ratings so as to mitigate potential conflicts of interest?

Yes. See our comments on the preceding point.

Do you agree with CESR’s view of the benefits and costs of the current regime?

We are in sympathy with the analysis presented by CESR.

Do you agree that CESR has identified the likely benefits and costs related to formal regulatory action?

Yes.

Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation?

As noted earlier we will review our position when the reports from IOSCO, CESR, ESME and others have been published. For the time being we maintain our preference for a self-regulatory regime based on a global approach which to date has been provided by the IOSCO Code.

