SJ - 2295/Div.

Mr Fabrice Demarigny
Secretary General
Committee of European Securities Regulators (CESR)
11-13, Avenue de Friedland
75008 Paris

Paris, 10 September, 2007

AFG RESPONSE TO CESR'S QUESTIONNAIRE REGARDING THE RATING OF STRUCTURED FINANCE INSTRUMENTS

Dear Mr Demarigny,

The Association Française de la Gestion financière (AFG)[1] welcomes both CESR's questionnaire regarding the rating of structured finance instruments and CESR's decision to extend the deadline for responses.

For several years now, AFG has been actively contributing to European discussions and consultations relating to Credit Rating Agencies (CRAs), either directly or through the European Fund and Asset Management Association (EFAMA) in particular.

Regarding this CESR's questionnaire, we wish to make first some general remarks, which will be followed by some specific ones.

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 365 management companies and 772 investment companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing more than 2500 billion euros in the field of investment management, making in particular the French industry *the leader in Europe in terms of financial management location* for collective investments (with nearly 1500 billion euros managed, i.e. 22% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, *and ranks second at worldwide level after the US*. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes funds and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

I. *General remarks*

AFG represents nearly 400 management companies. Thanks to this wide scope of representation, we have to mention that some AFG's members are regular users of structured finance instruments, some other members are occasional users of such instruments while others do not deal at all with structured finance instruments.

Therefore, this diversity of experiences allows us to express the following remarks.

Let us first stress that CRAs are not responsible for the *use* made of their ratings by market participants. Investors have their own responsibilities in taking their investment decisions.

However, for our members, some general issues regarding the *rating* of structured finance instruments must be raised before CESR.

First, investors (including professional ones) must be able to rely on clear, fair and unbiased information when taking their investment decisions.

Second, regulators – and legislators – at national, European and international levels, have to think about their own responsibilities in the development of ratings in recent years, through the importance they have given to the ratings themselves (not only for structured finance instruments) in their relevant regulations and legislations. For instance regarding Basel 2, the decision by legislators to reinforce the regulatory role of ratings obviously helped to develop the influence of such ratings – even though an alternative allowed approach is for players to make use of internal assessments.

Third, as this regulatory role of ratings has been increased by regulators and legislators, it makes sense for professional investors to use them more widely – with an increased potential systemic risk.

Therefore, today, both regulators/legislators and professional investors are at a cross-road.

Either a decision is taken to give less weight to ratings in financial regulations/legislation, at national and international levels. Obviously this option cannot be completely followed, because in particular professional investors have already made organisational and structural efforts in recent years to take into account this new, reinforced role given to ratings by regulations/legislations. Nevertheless, it remains that this type of regulatory/legislative decisions should not be taken in the future without a thorough analysis of its potential consequences and that ratings should not be seen as a remedy to all problems.

Or, as another option, regulators/legislators should decide to try to be more consistent in their regulatory approach of ratings.

For instance, when CAD 3 was under preparation in the European Commission, as such a piece of European legislation was going to give more weight to ratings, it would have been consistent to take another legal action at the same moment vis-à-vis the professional entities providing for such ratings. *As soon as ratings are becoming regulatory references, it is crucial to ensure that the way they are elaborated is also covered by regulation/legislation*.

Moreover, lets us stress that although ratings themselves are recognised by European regulations and legislation, the entities providing for them are the single major type of market participants which is not regulated: issuers are regulated, banks are regulated, brokers are regulated, financial analysts are regulated, asset managers are regulated. But not rating agencies.

The aim should not be to regulate rating agencies for the sake of regulation, but just to ensure a regulatory oversight on them, considering that the quality of ratings – which is crucial as soon as ratings are becoming a regulatory reference – derives from the quality of the organisation and functioning of CRAs.

We think an opportunity was missed in 2004 in the European Union, when in parallel to the elaboration of CAD 3, the European Commission decided to postpone the decision for regulation of CRAs. At that time, the European Parliament had asked for regulatory action. The Commission decided to deliver a mandate for scrutiny by CESR, but since then the progress towards regulatory action was rather slow.

We understand that the European Commission preferred to wait first for the United States to revisit their own oversight approach (NRSRO framework) in order not to harm the main CRAs, which are US-based.

But now, time has come to pass, in the European Union, from consultative action to regulatory action on CRAs. Only such a regulatory action will give confidence to the whole range of market participants, and will at last ensure consistency between on the one hand the regulatory role of ratings (given in recent years by national and European regulators/legislators) and on the other hand a first step of regulation on entities providing for them. *Moreover, as soon as the European Union provides for regulatory references to ratings, it cannot just rely on non-European legislation regarding the entities providing for them, i.e. CRAs.*

II. <u>Specific remarks</u>

B. Questions addressed to the users of ratings and other interested parties

Rating methodologies

We have a deep concern on the fact that some CRAs use the same type of rating for structured finance instruments and sovereign debt instruments for instance. Such an approach might appear as misleading, as a triple A (for instance) gives rarely the same level of safety for a structured finance instrument and for a sovereign debt instrument. Ratings for structured finance instruments should not be similar, in their form, to ratings applicable to other categories of financial instruments.

For instance, according to Charles Calomiris (Henry Kaufman professor of financial institutions at Columbia University) and Joseph Mason (professor of finance at Drexel University), quoting Bloomberg Markets, while corporate bonds rated Baa by a CRA had an average 2.2 per cent default rate over five-year periods from 1983 to 2005, CDOs rated equally Baa by the same CRA had –before the recent crisis – an average five-year default rate of 24 per cent[2]. We consider that delivering the same level of rating in the two cases (considering that the default rate is clearly not the same in the two cases) might be misleading.

Potential risks (conflicts, resourcing)

The main risk we identified for the rating of structured finance instruments is the following.

Usually, for the classical market of corporate securities, the market power of issuers is potentially lower than the market power of CRAs. The major CRAs are only a few, when the number of issuers is high.

On the contrary, for structured finance instruments, there are a few big structurers. As the structured finance instrument market is rather new, market shares between the main CRAs are

[2] FT.com, "*Reclaim power from the ratings agencies*", 24 August 2007

not stabilised yet. There is therefore a potential risk that some of these structurers might create competition between the main CRAs, in order to get the best ratings.

It is clear that potentially there are common interests between structurers and CRAs. Structurers have to disseminate the instruments they have structured, and therefore need the help of CRAs as an external reference to rate the quality of such instruments. From their side, CRAs have to provide for the best rating in order to take new business (or to keep business) from structurers and to develop their revenues on this new segment of activity. Of course structurers have an interest to avoid CRAs losing their credibility in the medium term. However, we cannot fully exclude that the situation on the structured finance market might have induced optimistic ratings in order to sell more easily some of these instruments (to get more fees).

For instance, we want to draw CESR's attention on the percentage of revenues such ratings might provide to CRAs. According to the Financial Times in an article published recently[3], structured finance has represented a growing percentage of revenues for one of the main CRAs (from below 40% until 2001 to more than 50% in 2006 – sources: the CRA itself and Thomson Datastream). It is clear that as soon as a segment of activity reaches such a level of revenues, there are potential risks. It is clear that regulation must not put caps of revenues by segment of activity, but at least a mandatory regulatory oversight by regulators would limit the potential risks linked to a prominent segment of activity.

The point is that professional investors need crucially the opinion of CRAs for such instruments. Clearly in the case of synthetic CDOs, the main added value of CRAs is first to develop a comprehensive and mathematical analysis of the relevant securities. But they are also supposed to have access to inside information and therefore better placed to assess the quality of such instruments, as compared to the professional investors themselves which are not allowed to get access to such inside information.

Furthermore, in some cases CRAs may have helped the structurers to elaborate the structured instruments – another type of conflicts of interest. As stated by the Financial Times recently: "*Rating agencies do more than opine; they play an active role in structuring RMBS and CDOs*"[4].

Regarding resource and experience in CRAs, we do not think that they are always insufficient. But the first issue is how to make sure that these resource and experience are used in a fair way. And more widely, beyond resource and experience, the second and more general issue is why not to provide for regulation on CRAs when regulators/legislators give a regulatory role to ratings?

IOSCO Code on Structured Finance

In our view, as soon as European legislation has introduced regulatory references to ratings, it is necessary to provide (beyond codes of conduct) for European legislation as well on the entities providing for such ratings, i.e. CRAs.

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[3] FT.com, LEX, 15 August 2007, title : "*Credit ratings agencies*"
[4] FT.com, UK, 24 August 2007, title : "*Reclaim power from the ratings agencies*"

If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), Stéphane Janin, Head of International Affairs Division, at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or Catherine Jasserand, Deputy Head of International Affairs Division, at 01 44 94 96 58 (e-mail: c.jasserand@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon