

EBF Response to CESR Consultation on

The role of credit rating agencies in structured finance/ CESR ref. 08-036

Introductory remarks

1. The European Banking Federation (EBF)¹ welcomes the opportunity to comment on CESR's assessment and proposals with regard to the role of credit rating agencies in structured finance.
2. The EBF's broad membership includes banks involved at different stages of the value chain around structured ratings, including issuers, arrangers, and users of the ratings. We were also closely involved in the previous discussions around ensuring the adequacy of ratings. We have been a firm supporter of the IOSCO Code of Conduct from the outset, agreeing that ratings represent a statement of opinion which it would not be appropriate to regulate as such.
3. However, we fully agree that there are a number of urgent issues to be considered further and find CESR's consultation paper very helpful for that purpose, including the clear description of the differences between corporate ratings and structured finance ratings as well as potential implications for the rating process.

Executive summary

4. The EBF agrees with most of CESR's assessments and proposals. Notably, we **endorse the recommendations for enhanced transparency with regard to e.g. the models and methodologies; the staffing situation and staffing policies; CRAs' interaction with issuers and arrangers; and remuneration policies.**
5. We would also support that the IOSCO Code of Conduct be amended to give **reinforced consideration to the due monitoring of ratings.**
6. **Clearer guidelines for the interaction between CRAs and issuers and arrangers, as well as clearer definitions for core and ancillary services** would equally find our support.
7. Clearer, better targeted and easily accessible communication would be an additional helpful step to enhance the functioning of the market's use of structured finance ratings.
8. All of these suggestions can however be **made within the existing Code of Conduct.** Indeed, the CRAs' responses to CESR questionnaire suggest that the Code has been endorsed to a large extent to date. **It is also not clear that either its**

¹ Set up in 1960, the European Banking Federation is the voice of the European banking sector, with over 30000 billion EUR assets and 2.4 million employees in 31 European countries. The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

full endorsement or hard-coded legislation would have made any difference in the recent events.

9. Rather than a sign of market failure or of failure of the Code, the EBF interprets the recent events in the first place as a learning process for the entire industry. The above recommendations are a partial result of that learning process, but their necessity is now apparent largely thanks to the benefit of hindsight. The **amendment of the IOSCO Code of Conduct is therefore in our view the most appropriate response** to address the issues around rating agencies.
10. In order to support the functioning of the Code, however, we believe that it would be useful for the **IOSCO to put in place a formal process of monitoring implementation and practical application of the Code's provisions** by the CRAs. This has to some extent been done by CESR so far, but given that the Code has been agreed at the level of the IOSCO it should also be policed at this level.
11. In addition to CRAs' written policies, we suggest that such monitoring also takes **account of cases of practical exceptions and insists on clear and comprehensive justifications** for such cases, which demonstrate how the underlying objectives of the Code can be achieved through alternative means. Other areas to be given particular attention in such a monitoring process mirror those identified in CESR's consultation paper, in particular staff resourcing, including remuneration and turnover; fee structures; and the quality of ratings.
12. Quality of ratings might e.g. be assessed on the basis of rating migration analysis, and we would suggest that **information about rating migration be standardised across rating agencies** and be made available in a prominent place and in an easily comparable way on their websites.
13. We finally underline the **primordial role of well-functioning competition in the rating market. Enhanced transparency is of great importance but can only deploy its full potential when accompanied by a sufficient degree of market competition and choice.** Care must therefore be taken to ensure that all measures agreed to address the shortcomings in the ratings market do not unduly hinder market entry for new respectively smaller CRAs. Such a development would indeed be likely to further aggravate the shortcomings of the rating market, instead of easing them.

Detailed responses to the questions

Transparency

<i>Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?</i>
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14. We agree with CESR's assessment, including that it is investors' responsibility to ensure due diligence and that their risk analysis and investment decision making

processes are robust and thorough. Investors will certainly take the necessary steps to review their processes and use of ratings.

15. At the same time, this process relies indeed on clearer information and communication from the CRAs. In reconsidering communication policies, the **emphasis must lie on quality, clearness, and ease of access to the information.**
16. Such high-quality information should be seen as part of the core business of rating agencies, as their ratings would be meaningless without users' full understanding of their remit and correct interpretation. It must therefore be available freely to everyone in the same way as the ratings themselves.

Do you agree with CESR's view 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 in particular so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings?

17. We agree with CESR and would welcome both enhanced usability of the websites and greater transparency with regard to model assumptions and weighting of key risk parameters, which were in the past indeed not always clear despite their significant bearing on the interpretation of a rating. This is e.g. as regards correlations between different pools of assets and the results of stress-tests.
18. In addition, we suggest that **CRAs provide a range of information complementary to the ratings themselves.** Given the one-dimensionality of ratings, this should facilitate investors' comprehensive analysis of the offered product, without exonerating them from their responsibility to gather additional information as necessary and to make their own assessment. Such information to be provided in addition includes e.g. the potential volatility of a rating, for example in the case of strong dependence on monoliners, and other crucial features of a product that are not reflected in the assessment of its credit risk as such, but might impact on the default risk in the future.

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

19. We **support CESR's recommendations as regards both flagging of the use of particular methodologies used for ratings, and the request of statements on whether changes in methodologies or performance have led to a rating review.** In these cases it should also be comprehensible what main difference in methodology has led to a rating adjustment.
20. We would expect that such clarity is more meaningful than e.g. the proposal that is sometimes made for the use of different rating scales for traditional ratings on the one hand, and structured finance ratings on the other hand. In this context, we also

note the difficulty of defining in the first place which products are considered to be “structured”.

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

21. The EBF would support the provision of standardised information about the performance of underlying assets, thereby allowing investors to “look through” the vehicle and carry out their own analysis.

Monitoring

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?

22. We concur that in view of the already ongoing automatic monitoring, additional public reviews by the CRAs would not provide significant added value and would not justify the additional cost and resource burden.

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?

23. The monitoring of ratings does indeed seem to be one of the particular challenges in the rating process. We would support the proposed **amendments to the IOSCO Code of Conduct as regards the importance of allocating sufficient resources to the monitoring and review of existing ratings, as well as ensuring that rating adjustments are made in a timely manner**. These aspects are closely linked to both staff qualification and CRA remuneration as addressed below, and we expect that enhanced transparency in these two areas would thus also have a positive effect on monitoring policies.

24. In our view, there is furthermore a need for **much broader and more comprehensive reviews of past ratings** than is currently the case. These reviews should be drawn up at least annually and be publicly available. In addition, we suggest that the IOSCO puts in place a **process of systematically monitoring the implementation and practical application of its Code** by the CRAs. Such a process should include an analysis of rating migration and timing of rating adjustments, with the results being made available to the public.

Human Resources

Do you believe that the CRAs have maintained sufficient human resource, 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?

25. We **share CESR's disappointment about the limited amount of data that seems to be available with regard to staffing, employee development and turnover levels.** This is all the more in view of the CRAs' acknowledgment that high quality of staff is one of their most important assets. Such information is of crucial significance and we hope that it will be available in the future.

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

26. We believe that it is in the **responsibility of CRAs, combined with and driven by market expectations, to determine the appropriate profile for their analysts.** We would therefore not necessarily be concerned that no change has been endorsed in the formal qualification profile for analysts, but would rather expect that the CRAs regularly review their requirements and be able to provide the reasoning underlying their (unaltered) requirements, e.g. as regards internal trainings and the functioning of the models used by analysts.

Do you agree there is a need for greater transparency in terms of CRA resourcing? Do you agree that more clarity and greater independence is required for analyst remuneration at the CRAs?

27. As noted above, information about staff resourcing is indeed of paramount importance in our view and should also include aspects of remuneration policies.

Conflicts of interest

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 managed properly?

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

28. With regard to the nature of interaction between issuers and CRAs in the process of structured finance ratings as such, we agree with CESR's assessment in §40 of its consultation paper that ratings in structured finance transactions have the role of a target, as opposed to the outcome of a classical rating process. That is in our view not necessarily problematic as long as the methodologies – or criteria – are clearly defined and independent, which is much helped by the public availability of the methodologies.

29. On the other hand, the fact that the structured finance business flows from a limited number of investment banks combined with the high importance of this income source and individual analysts' awareness about the business brought to the agency by a particular issuer can be seen as problematic in principle. It is not clear how this

difficulty could be avoided altogether, so that the active management of these conflicts of interest appears the best available option.

30. In our view, CRAs have done overall well so far in managing conflicts of interest. However, **transparency regarding the interaction with issuers and arrangers is of continuing high importance**, and **clearer guidelines** would seem particularly helpful against the allegations that have recently been made. In addition, **more information about fee structures and main sources of income** for rating agencies would facilitate market scrutiny.

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

31. Notwithstanding our above remarks regarding the management of conflicts of interest, we concur with CESR that **greater disclosure by CRAs over what they consider to be ancillary and core rating services** would be appropriate.

32. We have furthermore noted CRAs' decision not to provide any longer consultative services with e.g. hypothetical ratings for potential issuers. We welcome this decision and are confident that this role will be well assumed by independent third parties.

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?

33. Remuneration and fee structures are indeed of great importance, and we concur that the fee model used for structured finance products creates a potential conflict of interest. At the same time, we are concerned that alternative fee structures which would not be based on factors such as the issuance value and the complexity and innovative nature of the product might lead to unwelcome distortions of the structured products markets and to partial market failures. The due management of these conflicts of interest is therefore the most appropriate response to these difficulties.

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?

34. As noted above, we would indeed expect greater disclosure of fee structures and practices in this particular respect to be a helpful tool to mitigate potential conflicts of interest.

The Regulatory Environment and Concluding Remarks

Do you agree with CESR's view of the benefits and costs of the current regime? Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

35. We agree with most of CESR's outline of the costs and benefits of the current regime and of outright regulation as an alternative.
36. In addition to the suggested considerations, we believe that **explicit regulation might make market entry for new CRAs even more difficult** and thereby aggravate the oligopolistic situation. Such a **counter-productive result must be avoided and competition be stimulated rather than hampered**, against the background that CRAs' success depends in the first place on their credibility and market acceptance.
37. We are also not convinced as regards CESR's assumption that explicit regulation would provide greater incentives for the CRAs to be more diligent and work to avoid future failings in the ratings process. It is our experience that the **pressure to maintain their reputation** already provides good incentives to this effect, which could be improved by the **right transparency and disclosure requirements** along the lines considered by CESR.
38. We note that CESR seems to some degree disappointed with CRAs' compliance with the Code of Conduct. As opposed to this, the assessment of compliance is overall positive in our view. The possibility of exceptions was indeed foreseen by the "comply-or-explain" nature of the Code. If there is any criticism, then it should in a first instance **focus on the appropriateness of CRAs' explanations for non-compliance** in certain areas.
39. We also want to underline that it is in no way clear whether full compliance would have made any difference to the recently identified shortcomings, and even less whether their formalisation through binding legislation would have made such a difference. The focus should rather be on **full implementation of the existing and amended standards**, and we would see great merit in the **IOSCO monitoring compliance in a systematic way**.
40. We also note that the recognition process of CRAs for the purposes of the Capital Requirement Directive/ external ratings under Basel II can serve as a comparison and example for formal regulation, where the regulatory scrutiny does not seem to be substantially different in outcome from the market assessment. CRAs' processes and methodologies have to be developed further and are being developed further in light of the recent experience. It is right for the markets and authorities to demand high standards, but we doubt strongly that formal legislation would be able to further the practices beyond what can be achieved on the basis of the existing approach combined with high transparency standards.

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

41. The events of the last year have indeed raised a number of issues which must be addressed. However, these were difficult to foresee for anybody and we see them as a learning process for the industry as a whole, rather than a case of market failure or

failure of the Code of Conduct. In this respect, it does not seem to us that the events have changed the analysis of a case for regulatory intervention towards CRAs.

42. Against the above considerations, we therefore continue to believe that the **IOSCO Code of Conduct, combined with market pressure and enhanced disclosure requirements as well as regulatory monitoring of its due application is the most appropriate approach** to managing potential areas of concern around CRAs.

Summary and conclusion

43. The market turmoil has revealed a number of shortcomings with regard to CRAs' ratings of structured finance products. CESR's consultation paper provides in our view a good overview and identification of the process, as well as an analysis as to how structured finance ratings differ from the ratings of corporates and therefore need special consideration.
44. We believe that the **suggestions that CESR makes go in the right direction**, including in the areas of enhanced transparency in a number of aspects; clearer and better targeted communication; improvements in the monitoring of ratings; greater attention to staff resources and policies; and clearer guidelines on the interaction of CRAs with issuers and arrangers, as well as on the services to be considered core and ancillary, respectively.
45. All these **changes can be made within the Code of Conduct**. The fact that the Code has not been fully endorsed by the CRAs should not be seen as a sign of its failure – on the contrary, it appears to be complied with to a large extent. The Code allows for some deviations in line with the “comply-or-explain” approach, of which CRAs have made use. Before considering hard regulation instead of the Code, the focus should be on the explanations for non-compliance provided by the CRAs.
46. It is also far from clear that full compliance with the Code respectively its hard-coding into binding legislation would have made a difference in the recent market events. These events should rather be seen as a learning process for the entire industry, which provides a number of lessons including the need for significant amendments to the Code of Conduct.
47. We therefore suggest that more emphasis be put on the implementation of the Code in line with the “comply or explain principle”, and that IOSCO put in place a systematic monitoring process as regards CRAs' compliance with the Code. This should be similar to the reviews currently being undertaken by CESR but on the more appropriate level of the IOSCO and with additional consideration as to CRAs' practical application of the Code.