International Securities Market Association
International Primary Market Association
Danish Securities Dealers Association
London Investment Banking Association
Swedish Securities Dealers Association

We provide this evidence jointly in order to assist CESR by providing one document rather than five. For the purposes of its analysis of responses, CESR should however count this evidence five times, and weight it accordingly

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Comments on CESR's Call for Evidence concerning its response to the EU Commission's request for Technical Advice on possible Measures Concerning Credit Rating Agencies

General Comments

The above associations welcome the opportunity to comment at this early stage in CESR's consideration of the important issues which have arisen in recent years concerning this group of organisations which play a significant and growing role in the global capital market.

It is however regrettable that the Commission should have chosen to issue the Call for Technical Advice at the height of the European holiday season, thus denying CESR the valuable insights of many experienced practitioners. It would have been preferable for CESR, in this case, to offer a two month period for comment. We note that, based on the Indicative Timetable published with the Call for Evidence, CESR intends to provide for only a two-month consultation period (again including a holiday period) for its Draft Advice rather than the three months which has been generally agreed (including by CESR in its statement of consultation practices) as the minimum for new and important topics such as this. Even taking account of the Commission's deadline of April 1, 2005 for receipt of the Advice, we would question whether this timetable provides for an adequate level of consultation capable of fully identifying and eliminating potential unintended consequences of regulatory intervention. Of course, we will nevertheless encourage members to participate actively in future stages of the consultation process.

In preparing its Draft Advice we urge CESR to pay full regard to the Principles of sound securities market regulation as set out by the Lamfalussy Committee and endorsed and expanded upon by the Securities Experts Group (SEG) established last year by the Commission and whose report has been warmly endorsed across Europe. Key new Principles expounded by the SEG and particularly relevant to the treatment of CRAs are:

- Legislation should be evidence-based and subject to regulatory impact analysis

- Non-legislative solutions should be encouraged

- International competitiveness should be taken into account as a fundamental consideration in promoting the development of financial markets in the EU.

Taking those principles in turn we would note the following:

Advice should be evidence based

Before CESR was to recommend that regulation be extended to CRAs, it would be essential for it to bring forward concrete examples of problems and explain why it believed that regulation was the best and most proportionate solution.

While there is a certain amount of critical anecdotal comment about the behaviour of CRAs, particularly the Big 2, from certain sectors of European industry, as reflected in the Report of the European Parliament and the Concept Paper published by the US SEC, evidence of oligopolistic conduct has yet to be brought forward. Even if it were, the ***first*** steps, as recognised in the Resolution of the European Parliament (paragraph 16), lie with the competition authorities. As to numbers of CRAs, the Basel Committee has identified 130 agencies globally. In a Working Paper published in August 2003[1] it described in some detail several in Europe, including 7 in Sweden, 3 in Germany and 1 in Italy. We see no obvious constraint on these CRAs (or new entrants) developing a pan-European business, assuming they are willing and able to persuade investors, issuers and prudential and other regulators of their credibility. We recognise that for EU-based CRAs to expand globally requires their being able to achieve acceptance in the United States. That requires that the SEC finally resolves the NRSRO issue in a manner which facilitates the recognition of additional agencies, including, on a non-discriminatory basis, CRAs from outside the United States. We are therefore encouraged by the intention of CESR and the Commission to engage in dialogue with the US authorities on this issue.

From the perspective of investors, recent scandals such as Enron and Parmalat have undoubtedly shaken their confidence in the opinions of CRAs. However, to date, no specific operational failures by the CRAs have been identified in these cases. If that position were to change it would be appropriate that regulators should consider how best to minimise the risks of a repetition of the specific failure. The most appropriate solution could only be established after considering the facts and circumstances of the case and any steps taken by the CRAs and others to act upon the lessons learnt. A regulatory solution would not necessarily be the most appropriate.

It should also be recalled that credit ratings are ***not*** a forecast of default but an opinion of the relative probability of default. Even for 'AAA' borrowers that probability is not zero, albeit that it is some 200 times less likely (on recent historical experience) than for 'B' rated borrowers[2]. This subtlety may not always be apparent to retail investors and suggests that there is scope here for investor education initiatives to be undertaken, perhaps jointly, by regulators and CRAs themselves.

Non-legislative solutions should be encouraged

Much of the advice sought by the Commission covers areas which are not, at least at first sight, controversial. In fact, much of what is discussed represents good practice

[1] Basel Committee on Banking Supervision Working Papers No. 3 August 2003: 'Credit Ratings and Complementary Sources of Credit Quality Information'

[2] As quoted in Annex 2 to 'International Convergence of Capital Measurement and Capital Standards – A Revised Framework' published by the Basel Committee on Banking Supervision, June 2004

as carried out by many CRAs today. Standards of disclosure by CRAs have increased. For example it is now accepted practice for unsolicited ratings to be distinguished from solicited ratings. Furthermore, there appears to be a willingness among the leading CRAs to do more, provided the level of transparency does not extend to providing issuers with the means to exert pressure on them to 'improve' ratings. This being the case there appears to be ample reason to rely on further non-legislative initiatives in this area before moving to a legislative process.

Advice should promote the international competitiveness of EU industry

We have commented above on the need to obtain access to the US market for more European CRAs. We strongly support European initiatives here. It will be a necessary complement to that approach for regulators in Europe to be supportive of increased use of credit ratings in Europe and avoid introducing regulation that might hinder the expansion of existing European or third country CRAs or act as a deterrent to new entrants.

At the same time, in the context of the need to promote the international competitiveness of EU industry generally, and therefore the need to ensure that investors continue to have confidence in the published ratings of EU companies, it will also be important that the Draft Advice takes full and appropriate account of the final form of IOSCO's Code of Conduct for CRAs which we understand may be published in the course of its preparation. We expect that IOSCO will publish a draft for comment and we will be emphasising the value of this. We urge CESR members to support this effort in IOSCO.

The principal cause for concern: possible interference in credit rating methodologies

The element of the request for technical advice which has caused us the greatest concern and which we believe should be of equal concern to CESR, is the request for technical advice '*related to methodologies used for building credit ratings'* and in particular the first two bullets of that section which require CESR to take into account

- *the risk that inappropriate, undisclosed or weak methodologies might lead to biased credit ratings or to biased interpretations of credit ratings*

- *the possible consequent need to disclose or regulate such methodologies, taking into account an analysis of the relative risks of different regulatory and non-regulatory options.*

While we consider that a CRA should have procedures to ensure a degree of consistency in the application of its methodologies, this section appears to be an invitation to CESR to consider whether a regulator should have the power to intervene in the process by which a credit rating is arrived at and a power to over-ride the judgement of the CRA as to what is an appropriate methodology.

As such it ignores (1) paragraphs 11 and 12 of the Resolution of the European Parliament, (the reference to which in the Annex to the Call for Technical Advice is unduly selective), (2) the views of all market participants who gave evidence at the Parliament's public hearing, and (3) the views of the SEG which considered this matter and concluded that '*It is essential that the regulatory regime does not involve the fundamental credit judgement of the rating agencies or their independence.*'

Therefore we strongly urge CESR to advise the Commission that any intervention beyond requiring appropriate disclosure of methodologies is not only unnecessary but would also pose significant risks to both sides of the European savings equation.

In our view it would lead inevitably to the politicisation of the ratings process in Europe and the subsequent loss of credibility of the published ratings of EU companies seeking debt financing from banks and investors in the EU and globally. The damage to the international competitiveness of European industry, from the resulting increase in the cost of capital, would be considerable.

It would also result in a growing uniformity of methodology as CRAs were forced to adopt only those methodologies approved by European regulators rather than those valued by investors. Paradoxically, this would be likely to increase, rather than reduce, the possibility of the collective failure of CRAs to identify companies at growing risk of default, which has been one of the main arguments offered in support of regulatory oversight of CRAs. Again, such an outcome would lessen, rather than increase, investor confidence in the quality and integrity of the ratings process in Europe. Furthermore, to the extent governments are responsible for eliminating 'improper' methodologies they would be, or would be seen to be, taking some form of responsibility, be it political or financial, if the 'proper' methodologies led to failures in certain instances.

Finally, it is difficult to imagine how CRAs operating in Europe could be subjected to regulation of methodologies and still comply with IOSCO Principle 2 which states that:

'*CRA ratings decisions should be independent and free from political or economic pressures and from conflicts of interest arising due the CRA's ownership structure, business or financial activities'.*

Conclusion

This is a vitally important topic for European industry and investors in general. It is essential that CESR proceeds with due time for reflection and takes a proportionate and balanced approach in preparing its Draft Advice. In particular, it should vigorously resist the demands that CRAs active in Europe be put under pressure to express opinions which conform to some notional 'European' standard, distinct from international standards (broadly accepted by regulators, issuers and investors alike), and not easily delivered by the CRAs' own preferred methodologies which have been developed in conjunction with users of ratings. Where weaknesses in the operation of CRAs can be objectively identified we believe that there remains considerable scope for non-legislative or self-regulatory solutions and for competitive and commercial pressures to bring about necessary change.

August 27, 2004