

31 March 2008

CESR
11-13 avenue de Friedland
Paris
France 75008

Dear Sirs

**The role of credit rating agencies in structured finance
Consultation Paper, February 2008**

The IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail and investment banks and life insurers, and the managers of occupational pension schemes. They are responsible for the management of approaching £3 trillion of assets (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds such as pensions and life funds and a wide range of pooled investment vehicles.

While IMA members are significant investors in bonds and therefore review ratings assigned by credit rating agencies as part of their investment process, their exposure to structured products is minimal. As we pointed out in our response to CESR's consultation on credit rating agencies in February 2005, however, credit ratings are heavily relied on to describe asset allocation in client mandates or fund definitions. Moreover regulators are adopting ratings into some of their rules, which means they ought to have a considerable interest in transparent and robust practices. The IMA therefore does have a keen interest in the functioning of credit rating agencies in general and in particular how they manage their conflicts of interest.

The IMA's responses to the questions posed by CESR are contained in the Appendix to this letter. The IMA however would make the following observations:

- i. IMA members believe that the self-regulatory regime introduced in 2005 whereby CRAs would voluntarily comply with the IOSCO Code of Conduct has led to an improvement in transparency in the corporate bond market.
- ii. IMA members view the agencies' ratings as just one opinion amongst many which they assess when coming to an investment decision. The rating of a bond, moreover, does not actually tell the investor anything about the value of the instrument at any point in time. One member commented that the use of ratings in asset management is "very old-fashioned".
- iii. It is important to distinguish between the ratings process for corporate bonds and that for structured finance. The former has more integrity in that it is based on the analysis of a specific company. Structured finance however

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relies on mathematical modelling of expected default rates and correlation of default within the underlying asset pools. These models have clearly proved to be flawed.

- iv. There is over-reliance on credit ratings as an objective standard of quality:
 - By investors who do not have access to unconflicted credit analysts (in contrast UK-regulated asset managers who commonly have a team of their own analysts);
 - In investment regulations and also less-sophisticated investment mandates which draw absolute distinctions between investment-grade and other instruments;
 - In capital regimes, and unsophisticated models based upon them; and
 - More generally, as for example where the UK water Regulator (Ofwat) imposes a licence condition upon water companies that issue debt to maintain an investment-grade rating from S&P, Moody's or Fitch or any other UK or US "reputable credit-agency".
- v. CRAs are increasing research content on their web-sites for which they charge investors. Some participants believe that if they do not subscribe, then they can be at a disadvantage to their peers, and that information relating to a publicly traded bond should be freely available.
- vi. IMA members question whether CRAs should have the level of access to non-public information that they appear to, especially as it leads to their ratings having undue status, particularly among retail investors.
- vii. IMA members do not support the idea of an oversight board as such a structure would only serve to enhance the reputation of the CRAs' ratings, rather than diminish them. IMA members however would support the establishment of a trade body for the industry with whom regulators and investors could engage on specific issues.
- viii. IMA is concerned that CESR may be closing the stable door after the horse has bolted. It is clear that some CRAs have already reduced their operations in structured finance and it is likely that the market will end up being a fraction of the size it has been in recent years. It would be unfortunate if CESR were to spend a significant amount of time looking at the disclosure for certain products which the market has already decided will not be used any more.

The IMA would encourage CESR to co-ordinate any action it may take regarding rating agencies with IOSCO whose consultation regarding proposed changes to its Code of Conduct Fundamentals for Credit Rating Agencies has only just been published. The IMA is particularly interested in the proposal regarding "ratings shopping" whereby the CRA should disclose all cases where an issuer has supplied all relevant information but where the CRA is not contracted to issue the final rating.

Should you have any queries then please do not hesitate to contact me.

Yours faithfully

Liz Rae
Senior Adviser – Investment and Markets

Appendix

Q1. Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?

The IMA would agree that there is some merit in the CRAs better clarifying the limitations of their ratings although IMA members, as professional investors, do understand that a rating is describing solely the probability of default, and the potential loss in the event of default.

Q2. 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?

The IMA believes that transparency of methodologies is key to investors' ability to understand how a rating is arrived at, particularly in structured finance products. It is entirely appropriate that CRAs should also publish the assumptions, such as default history and correlations, which have been used in modelling the rating. Investors can then assess whether they agree with those underlying assumptions, and make an informed decision.

Q3. 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?

The IMA agrees. That investors were not sure whether a rating had been changed due to a change in methodology or due to a change in credit quality is unacceptable. If some ratings continue to be based on an old methodology, then that should be clearly flagged.

Q4. 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?

The IMA would encourage CESR to consider the European Securitisation Forum's (ESF) report to the EU Commission, as well as a consultation paper from IOSCO which has recently been issued.

Q5. 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?

The IMA agrees with CESR's cost/benefit analysis and that contractually set public announcements are too inflexible to encompass a sudden change in circumstances. It would merely be a box ticking exercise.

CESR states that monitoring timetables are typically driven by the regularity with which data is received on the underlying collateral pools. The IMA would urge the rating agencies to take a more proactive approach to their monitoring, rather than reactive, by for example assessing the likelihood that external events may have an impact on the collateral pool. If the likelihood was high then the agency could put its rating under immediate review. By the time the product is performing outside of its expected parameters, it is then too late for the investor.

Q6. 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?

The IMA agrees that the monitoring of structured finance products probably does present challenges due to their complexity and that it should be a specific area of oversight going forward. There is a clear conflict of interest within the CRA whereby the origination of new ratings is where the growth of the business comes from and where the bulk of the revenues come from. The agency would typically allocate its best analysts to origination. There therefore needs to be an incentive for the agency to devote more and better resources to monitoring. The CRAs would argue that reputational risk drives high quality monitoring, but this has clearly not been the case in recent months. A stronger statement in the IOSCO Code should certainly be considered as a starting point. At the end of the day however it is up to the agencies to manage their business efficiently and resource it effectively so that the market has confidence in their opinions.

Q7. 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?
Clearly not.

Q8. Do you consider that the generally unaltered educational and professional requirement of CRAs recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

The IMA believes that it certainly does not reflect well on the CRAs that they have generally not updated their educational and professional requirements in their recruitment policies during a period when financial markets have changed out of all recognition.

Q9. Do you agree there is a need for greater transparency in terms of CRA resourcing?

The IMA believes that it would certainly help investors assess the depth of resource available to the CRA. That might only be achievable however if the CRAs were asked to number and rank their analytical staff by status and experience and to disclose analytical staff turnover. Anecdotally the IMA understands that, while structured finance analysts may have excellent academic qualifications e.g. doctorates, their commercial experience in financial markets is minimal.

It would however appear to be the case that CRAs generally are now exiting some of their structured finance operations and laying off staff. Perhaps they have made the decision that the business is not just in a cyclical downturn but is no longer attractive longer term.

Q10. Do you agree with CESR that more clarity and greater independence is required for analyst remuneration at the CRAs?

If there is evidence that analyst remuneration is adding to conflicts of interest already inherent in the role of the CRAs then that needs to be addressed. IMA wonders whether the credit crunch has dealt with the issue in that a reallocation of resources is already taking place and reducing the worst examples of mis-aligned incentives.

Q11. 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?

As CESR points out earlier in the consultation document, the rating of structured finance products is a repeat business whereby the issuers of the products will bring regular business to CRAs, in contrast to rating corporate bonds where the business is more sporadic. This has to constitute a conflict of interest for CRAs as they are keen to continue to originate business with issuers, giving rise to an incentive to assign favourable ratings. The IMA has no opinion as to whether these conflicts are well managed or not.

Q12. 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 needs to be clearer definitions of acceptable practice?

IMA members believe that the CRAs' relationships with the investment banks should be put under more scrutiny. Clearly the agencies are treading a very fine line between offering a core rating service and what might appear to be ancillary advisory services. Clearer definitions of acceptable practice should be considered by IOSCO.

Q13. Do you believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business?

The IMA agrees. Definitions of "core" and "ancillary" however would have to be agreed and standardised across the industry.

Q14. 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?

Yes. Regarding the second question, the IMA cannot comment on whether CRAs manage this conflict of interest appropriately but the conflict is clearly there in that there is every incentive to assign a favourable rating so that the issue is a success and the fee is earned.

Q15. 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?

Apart from the commercial sensitivity of disclosing such information, the IMA would point out that the more the CRAs have to explain their practices the more issuers will model to meet those practices and standards.

Q16. Do you agree with CESR's view of the benefits and costs of the current regime?

The IMA agrees with CESR's assessment of the benefits and costs of the current regime. The IMA would emphasise that the benefits of self-regulation however far outweigh the costs and particularly that there is no "official" recognition attached to ratings thereby giving what are merely opinions undue status.

Q17. Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

The IMA agrees with CESR's assessment of the benefits and costs of a formal regulatory regime. Again however the IMA would emphasise that the costs of regulation would far outweigh any benefits, particularly leading investors and regulators to place too much reliance on what are merely opinions.

Q18. Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation?

The IMA strongly agrees with maintaining the current self-regulatory regime for the reasons outlined in Qs 16 and 17. It is not clear that there is a market failure. Investors regard ratings as merely an opinion and the more weight that regulators put on an opinion, the more difficult it is for the credit analyst to change, thus slowing down opinion forming. Ratings are just one input into investors' decision making process and as with all opinions, can be wrong. That is not a market failure but a case of poor judgement.

The IMA believes that any form of registration/regulation will raise barriers to entry and that it should be the role of the regulator to encourage more competition. Competition in the ratings' process will encourage a higher level of analytical input and thereby improve the quality of ratings overall.