CJ/SJ- Div.

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

Paris, March 31, 2008

AFG RESPONSE TO CESR CONSULTATION PAPER ON THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE

Dear Mr Comporti,

The Association Française de la Gestion financière (AFG)[1] welcomes the CESR's consultation paper on the role of credit rating agencies (CRAs) in structured finance.

We congratulate CESR for the work undertaken on this issue. We take the opportunity of this consultation to stress that the question of regulating or not regulating CRAs is not limited to their role in structured finance. While weighting the pros and cons of a regulation of the CRAs, CESR must on the one hand take into consideration the reality of the market with only three major global CRAs and on the other hand ensure that investors can make informed investment decisions.

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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 405 management 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 second at worldwide level after the US*. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes 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).

Although it is not true that CRAs are not responsible for the *use* made of their ratings by market participants, asset owners and managers having their own responsibilities in taking their investment decisions, some general and important 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. We regret that CESR did not stress this responsibility of regulators themselves in having given a very high regulatory role to ratings – while not enough anticipating in parallel the way such ratings had to be elaborated/defined and their providers organised.

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 currently.

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

- 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 easily 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 and CRAs.

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 regulatory/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/defined is also covered by regulation/legislation.*

The aim should not be to regulate rating agencies for the sake of regulation, but at least 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 – although we recognise here that CESR has worked hard on the topic until today.

We understand that in 2004 the European Commission preferred to wait first for the United States to revisit their own oversight approach (NRSRO framework)..

But now, time has probably come to pass, in the European Union, from consultative action to more regulatory action on CRAs. Only such a more regulatory action will bring back some confidence to market participants, and will at last ensure a minimum 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/reinforced self-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.

In addition, before answering to the specific questions and discussing the main issues raised by CESR in its consultation paper, we want to make the following comments:

- First, the choice to be made by CESR between reinforcing self-regulation or requiring regulation as such should come only *after* assessing the improvements needed to answer the current identified issues. The choice of the regulatory tools cannot be decided ex ante on an ideological basis, but only ex post, after a fair assessment of issues and responses to be given to these issues;

- Second, the choice is not only between regulation and self-regulation. Our preferred solution for the near future would be to propose reinforcing the current content of self-regulation (through the IOSCO Code and adjusted recommendations made by CESR) <u>together</u> with the monitoring by national regulators (and/or CESR) of CRAs' compliance to such self-regulation. Should self-regulation – or compliance of CRAs to self-regulation - appear as insufficient, we would encourage CESR to recommend the European Commission to regulate CRAs or to give regulatory powers to CESR.

Last general remark: we regret that CESR has not raised as such the issue of **methodology** in ratings. This is the central issue today. The topics raised by CESR, i.e. transparency, monitoring, human resources and conflicts of interest, do not directly address it. Therefore, we will introduce some comments on it within each of the sections suggested by CESR, where appropriate.

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Elements of discussion on the main issues:

<u>1. Transparency:</u>

Let us first recall that efficient ratings can be considered as a sort of "common good", which relies in particular on the ability of rating agencies to have access to all the necessary inside information from the relevant issuers – contrary to investors, including institutional ones. Thus, ratings allow for reducing the asymmetry of information which structurally exists between CRAs and investors. It therefore requires that an appropriate transparency be applied to such ratings due to such a prominent role – which was reinforced in recent years through the regulatory status given to ratings by regulators, as mentioned above.

However, let us recall as well that *transparency cannot be considered as the panacea and as a full substitute to improving the methodology used by CRAs.*

For instance, two types of discrepancies hit in practice the meaning of ratings currently.

First, according to CRAs themselves, in theory the meaning of a rating is absolute, regardless of the relevant country, financial instrument, etc. E.g. one major CRA wrote in 2004: "*the comparability of these opinions holds regardless of the country of the issuer, industry, asset class or type of fixed-income debt*". Another major CRA wrote in 2007: "*our ratings represent a uniform measure of credit quality globally and across all types of debt* *instruments. In other words an 'AAA' rated corporate bond should exhibit the same degree of credit quality as an 'AAA' rated securitized issue*".

However, in practice, it appears that the actual behaviour of rated obligators or instruments may turn out to have more heterogeneity across countries, industries and product types[2]. In particular regarding structured instruments, it appeared in the subprime turmoil that AAA ratings appeared less stable than normally expected for this class of assets, with examples of downgrades of several notches in a day.

Second, the rating agencies differ about what exactly is assessed. Whereas some major CRAs evaluate an obligor's overall capacity to meet its financial obligation, and hence is best through of as an estimate of probability of default, the assessment of another major CRA incorporates some judgement of recovery in the event of loss. The first ones measure what is called "PD" (i.e. Probability of Default") while the last one measures something which is closer to "EL" (i.e. Expected Loss")[3]. In the specific case of structured products, one major CRA stated in 2007: "*we base our ratings framework on the likelihood of default rather than expected loss or loss given default. In other words, our ratings at the rated instrument level don't incorporate any analysis or opinion on post-default recovery prospects.*" By contrast, another major CRA incorporates some measure of expected recovery into their structured product ratings.

But legislations/regulations do not introduce such nuances in the meaning of ratings. For instance, in Article 18 of MiFID Level 2, there is a reference to the "*highest available credit rating*" as a necessary condition to consider some securities as high quality money market instruments. But such "highest rating" is not defined – and therefore could potentially differ in its meaning from one CRA to another one. Similarly, in Article 6 of UCITS Directive Level 2 on eligible assets, some issuers must fulfil at least the requirement of having "*at least investment grade rating*", but without any further definition. Many other references could be quoted either.

These differences in methodologies mean that ratings themselves may have different meanings depending on their providers. As far as ratings are introduced in legislations/regulations without these nuances, we can wonder whether it makes sense *not* to define the meanings of these ratings, regardless of their relevant providers. Couldn't regulation – or self-regulation - introduce some elements of harmonisation on the meanings of ratings?

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

Yes, in particular it is safer to better clarify that ratings are not liquidity indicators. **However, it leads to wonder how to develop ratings which would take into account the liquidity risk. In any case, the role and importance of the liquidity risk should be acknowledged and better factored.**

Q: 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?

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[2] See for instance P. Nickell; W. Perraudin and S. Varotto, 2000, "*Stability of Rating Transitions*", Journal of Banking and Finance, 24, p. 203-227 – for evidence across countries of domicile and industries for corporate bond ratings. See also the Committee on the Global Financial System (CGFS), 2005, "*The Role of Ratings in Structured Finance: Issues and Implications*" – for differences between corporate bonds and structured products.

[3] See the analysis provided by the Basel Committee on Banking Supervision (BCBS), 1996, "*Amendment to the Capital Accord to Incorporate Market Risks*", Basel Committee Publication n°24.

Yes. We support CESR's analysis that investors need to be able to determine key model assumptions, such as default correlations and weightings. An understanding of the key underpinning assumptions, such as the estimated correlation of obligors in the asset pool or the cross-correlations, would greatly assist investors in assessing whether the rating is based on expectations that are in line with their own. The potential impact that changes to these assumptions, correlations and weightings have on the ratings themselves should also be highlighted. It would be regrettable if CRAs were going to develop this as a separate service.

Q: 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?

Yes, it can prove difficult today to track which evolution of the particular methodology has been used to rate or review specific issuances. A clear labelling of ratings to indicate against which version of a methodology those ratings were based on (including a link to the specific model) might be useful. CRAs should be clear as well as to whether a change in methodology or performance in underlying asset pools has lead to a rating review.

Q: 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?

It is true that structured products, when they do not take the form of UCITS or UCITS-like funds, can be –even if it not systematic- not transparent enough (see our answer to the European Commission's consultation on 'substitute products').

We think that transparency should be reinforced on:

- underlying portfolio components
- correlation components
- stricter justification on determination of the implicit volatilities taken into account for structured products embedding options, as today it is often difficult to understand the levels of implicit volatilities taken into account for the final pricing of structured products by issuers

Beyond the specific points identified by CESR to be made more transparent, we want to stress a major point according to us, regarding *symbologies*: it appeared misleading during the subprime turmoil to apply the same symbology to different categories of financial instruments[4]. Structured products are ad hoc products, which need adapted rating symbology and scales, and not standardised ones. Disclosing the methodology used to set up the rating is not enough: ratings for structured finance instruments should not be similar, in their form, to ratings applicable to other categories of financial instruments[5].

In addition, we think that adding some information to the rating itself, such as its volatility in time of market or liquidity stress, would bring some improvement to the current situation.

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[4] See for instance L. Clerc, "*A primer on the subprime crisis*", Banque de France Occasional Paper n°4, February 2008

[5] 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. 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. *(see FT.com, "Reclaim power from the ratings agencies", 24 August 2007).*

Therefore, at least two ways could be proposed (or even combined): either adopting another rating scale for structured products (with another symbol for example); and/or including an additional measure in the credit rating, in particular on its volatility in times of market or liquidity stress.

2. Monitoring:

Q: 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.

Q: 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?

It is difficult to say. In any case, rather than the issue of sufficient resources to be allocated by CRAs to the monitoring and review of existing ratings, we think that such a monitoring can probably be improved by a better organisation of CRAs, but without necessarily requiring additional resources. However, the issue of monitoring the structured finance products is linked to the human resources in another way: no proper monitoring can be done without adequate staff (see right below).

3. Human Resources:

Q: 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?

It is difficult to answer the question raised. It seems difficult to go beyond what CESR proposes, i.e. requesting agencies to have sufficiently advanced human resource management processes so that they are in a position to provide key trends in staffing, employee development and turnover levels. The core issue is not so much the number of people employed by CRAs but rather the recruitment of skilled and competent persons in structured finance to help rating the products. We are very surprised to read in CESR's consultation paper that only one agency expressed its need for recruiting experts in structured finance. The other agencies indicated '*they (had) not changed their educational and experience level request over the past 10 years despite the increased sophistication of structured finance products*' (para. 119).

Q: 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?

Once again, it is difficult to say. However, it is crucial that regulators – given the regulatory role they have given to the ratings themselves and the "common good" status such ratings play on financial markets – are able to check that such ratings are elaborated by professionals who possess the appropriate skills.

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

We are not certain of these needs. For us, what is crucial is *for regulators to check* that such resources fit with the missions ensured by CRAs, in particular in relation to the whole process of internal elaboration and review of ratings.

4. Conflicts of interest:

Q: 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?

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

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

We support the proposal suggested by CESR in para 130. But beyond the disclosure of possible conflicts of interest, CRAs should *avoid* as far as possible such conflicts of interest between the advisory services and the rating activity itself, following more clarity on what constitute advisory services in order to avoid any ambiguity. If such conflicts of interest cannot be avoided, then CRAs should manage them in a clear manner. Regarding who should define what constitute ancillary business a compared to core rating services, obviously CRAs should be involved in this task but CESR as well – especially as each CRA might end with its own definition otherwise.

Q: 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?

Even though potentially such a fee model involves theoretical conflicts of interest, we are not sure that fee models should enter the current debate on CRAs.

Q: 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 interests?

It is not a priority for us.

5. CESR's Conclusive remarks:

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

Yes, globally. However, we want to recall to CESR that the inclusion of ratings was not done only in the banking environment, but also in the securities environment as already mentioned above. For instance in some countries, in the area of investment funds, a minimum level of ratings for the underlying assets is required in order to be classified as money market funds. That's why it appears as important to us that regulators receive monitoring powers to check CRA compliance with the IOSCO Code in particular.

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

Yes, to a large extent. However, there are some surprising analyses though.

For instance, CESR mentioned that market participants have in the past expressed concerns that formal regulatory action may threaten rating credibility/independence. In our view, the current debate on CRAs comes from a significant market failure on them, coming itself from an *insufficient* level of (self)regulation – or more precisely an *inadequate* content of (self)regulation as compared to the increasing regulatory status given to ratings by the regulators themselves.

In the same vein, we wonder why CESR asks if the issues which emerged with ratings of US subprime backed securities highlight a failure of the current regime, which could have been prevented if a formal regulatory regime was in place. It is difficult to state that it could have been prevented, but at least it showed clearly that *the current content of (self)regulation was not appropriate.*

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

As said in the introduction, the debate must not be ideological, between self-regulation and formal regulation. Our conclusion would be to favour an industry self-regulation based on IOSCO/CESR Code of Conduct, **with a monitoring role of CESR and/or its members** on the compliance of the CRAs with this self-regulation. The European Commission should at a later stage assess the efficiency of such self-regulation and decides whether a regulation would be necessary to grant **regulatory** powers – and not only **monitoring** powers - to the regulators over the CRAs.

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We thank CESR very much for taking into consideration our comments and remain at your disposal for any further questions. Please feel free to contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), our Head of International Affairs Stéphane Janin at 00 33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or his deputy Catherine Jasserand at 00 33 1 44 94 96 58 (e-mail: c.jasserand@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon