



COMPANHIA PORTUGUESA
DE RATING, S.A.

Lisbon, 21st October 2011

Dear Sirs,

Please find herewith Companhia Portuguesa de Rating, S.A. (CPR)'s contributions to Consultation Papers:

- Regulatory technical standards on the information to be provided to ESMA by a credit rating agency in its application for registration and certification and for the assessment of its systematic importance;
- ESMA's draft Regulatory Technical Standards on the presentation of the information that credit rating agencies shall disclose in accordance with Article 11 (2) and point 1 of Part II of Section E of Annex I to Regulation (EC) No 1060/2009;
- Regulatory technical standards on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009;
- ESMA's Draft Regulatory Technical Standards on the content and format of rating data periodic reporting to be submitted from credit rating agencies.

Kind regards,

José Poças Esteves

Pedro Braga da Cruz

General

It is generally accepted (see, for example the summary points raised in the roundtable on CRA promoted by the European Commission on the 6th July 2011) that it is a “concern (...) the oligopolistic structure of the credit rating market” and there is a “need to increase competition and to encourage more players in the market”. That lack of competition is the basis for worst quality ratings, higher prices for raising capital for issuers (that will depend on a few oligopolistic CRAs), higher prices to investors (that will end up paying the prices paid by the issuers) and higher risks to the financial markets (just remember where the present crisis began).



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As such, all legislation, and especially Regulatory Technical Standards should take this point in very serious consideration (not imposing fixed costs or barriers to entry in the sector), to avoid the aggravation of this oligopoly situation.

Ref. 1: Regulatory technical standards on the information to be provided to ESMA by a credit rating agency in its application for registration and certification and for the assessment of its systematic importance

1) This document is not clear whether CRAs already registered or with processes of registration in course will not have to submit new registration processes in the new format of these regulatory technical standards, which is substantially different from the previous Guidances published by CESR on the 4th of June 2010. If new documents will have to be submitted the fixed costs will be enormous, with an impact in competition in the rating industry.

2) This document does not mention the language that should be used in the registration process by a CRA with activity only in one country or a set of countries with the same language, as it was the case in previous Guidances published by CESR on the 4th of June 2010 (in the mentioned case, that CRA could send almost all the registration in its language). The need to send the documents in another language would increase costs to smaller CRA, again impacting competition on the rating industry.

3) This document does not mention if these regulatory technical standards apply to any future changes in present registrations: should the previous Guidances apply or the corresponding parts of these new regulatory technical standards apply? Again, due to the substantial changes in the structure of this regulatory technical standard versus the previous Guidances, there will be significant costs, with an impact in competition in the rating industry.



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Ref. 2: ESMA's draft Regulatory Standards on the presentation of the information that credit rating agencies shall disclose in accordance with Article 11(2) and point 1 of Part II of Section E of Annex I to Regulation (EC) No 1060/2009

As we have mentioned in the past, the following principles of CEREP are highly questionable and, in our view, not based on Regulation 1060/2009:

1) "ESMA does not disclose any individual rating information to the public but publishes aggregate statistics only" (paragraph 11): there is no reason not to publish individual rating information (there is nothing in Regulation 1060/2009 against it). It would be very useful for investors to have this information centralised, allowing them the distinction of the quality of the fundamentals of each rating, and it is already obligatory for each CRA to publish this information freely (so there is no proprietary question on this). Without individual ratings, outlooks and press releases, information is not complete (in opposition to what is mentioned in the first bullet of paragraph 8 of the paper), nor that information is particularly relevant to reduce the cost of information to investors (that have a special interest in the individual ratings), as mentioned in the fourth bullet of paragraph 8 of the paper.

2) As mentioned in paragraph 12, "several types of statistics are compiled and published for each credit rating agency", but CEREP does not permit users to aggregate data on several CRA. Again, there is no reason not to do it (there is nothing in Regulation 1060/2009 against it). This aggregation would be very useful, as it would allow:

- to have aggregated statistics by market or geographic segments, for example for academic or supervision purposes (without this aggregation, the help mentioned in the third bullet of paragraph 8 is very limited);
- to have sufficient scale to be able to back test data of small CRA with statistical meaning, aggregating them together; without this aggregation there is no statistical meaning in the comparison of statistics of small CRA, breaking the objective of protecting the investors (mentioned in the second bullet of paragraph 8), and in fact inducing them in error (ex: CPR will have a default rate equal to zero in all ratings except for the BBB).

3) CEREP mixes solicited and unsolicited ratings, when:

- CRA send the data distinguishing solicited from unsolicited ratings;
- solicited ratings have qualities much different from unsolicited ratings, for to produce them CRA have access to private information, accomplishing one of the main functions of ratings, which is to



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reduce asymmetries of information between issuers and investors (which is ignored by this mixture), which does not happen with unsolicited ratings; this is recognised by Regulation 1060/2009 that requires in paragraph 21 of its introduction that “unsolicited credit ratings (...) should be clearly identified as such and should be distinguished from solicited ratings by appropriate means”; in mixing solicited and unsolicited ratings CEREP is biasing its statistics and is not complying with Regulation 1060/2009;

- this mixture of solicited and unsolicited credit ratings in CEREP benefits the big CRA, which produce more unsolicited credit ratings, increasing the sample of their data and the statistical significance of their statistics, again negatively impacting on competition on the rating industry;
- 4) Cost – benefit analysis: it is important to mention that the costs to answer the requests of CEREP by the CRA are essentially fixed costs, that penalized smaller CRA, not helping the competitiveness in the rating industry. The fact that there is no information on each individual rating and not being possible to aggregate data from various CRA are again measures that penalize smaller CRA, and, as such, that do not help either the competitiveness in the rating industry.

Ref. 3: Regulatory Technical Standards on the assessment of compliance of credit rating methodologies with the requirements set out in Article 8(3) of Regulation (EC) No 1060/2009

Some of the principles incorporated in these regulatory technical standards deserve to be rethought:

- 1) Ratings are not only the symbols, but also the outlooks and the fundamentals for their attribution. As such, back testing based on the symbols of the ratings is inadequate to validate ratings based on historic experience, because:
- it penalizes small CRAs, that have a lower number of data to present and, as such, will not be statistically significant, which means it is not helping the competitiveness in the rating industry;
 - it is theoretically doubtful: since Altman studies on defaults that it is known that defaults have different behaviors from industry to industry and from country to country and default rates from one industry or country can not be used to another industry or country: that is exactly what happened in the sub prime crisis in the US, with default rates bigger than 30 times what they were supposed to be based on statistics from all industries and countries of the Americans CRA;



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so, if the back testing is to be done based on statistics, it should be done industry by industry and country by country, and not CRA by CRA;

- even considering all countries and all industries for the bigger CRAs, it has no statistical significance: it would be necessary to have a minimum of 22 notches x 40 observations per notch = 880 ratings for default rates to begin to have some statistical significance; and 22 notches x 22 notches x 40 observations = 19360 ratings for transition matrixes to begin to have some statistical significance;
- back testing in this way is against Regulation 1060/2009: in paragraph 23 of its introduction it says that “those requirements should not be applied as to prevent new credit rating agencies from entering the market”;
- back testing based solely on the rating symbols increases the mechanical use of ratings that has been so much criticized in the last few years, giving the wrong incentives to investors, that should incorporate ratings and their fundamentals in their own analysis and not blindly trust them.

To validate ratings based on historic experience, including back testing, we would suggest to focus on the quality of the fundamentals pointed by CRA in their press releases and in their public rating reports, for which the first steps should be to oblige CRA to freely publish them and to give incentives to investors to incorporate them in their analysis.

Please note that Regulation 1060/2009 does not mention anywhere that the back testing should be done based on statistical measures calculated on the symbols of the ratings, but simply that “a credit rating agency shall use methodologies that are (...) subject to validation based on historical experience, including back-testing”, which is perfectly compatible with the suggestion in the previous paragraph.

- 2) There are a lot of measures in this regulatory technical standard that imply fixed costs and, as such, do not help either the competitiveness in the rating industry.
- 3) Conflicts of interest should be cleared and lack of common sense deeply supervised to guarantee rigorous methodologies: some (real examples)
 - how can a CRA be independent in rating a Portuguese bank if it received fees from the same bank to set up its internal rating system? It should be absolutely forbidden to rate an issuer or an issue from an issuer from which the CRA received material non-rating revenue in (say) the previous five or ten years;
 - how can one say there is a rigorous methodology when there is lack of common sense?

Long term Ratings of Moody's / S&P (number of notches below Portuguese Republic)



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Portuguese Republic	Ba2 / BBB-
CP (railway company: 100% of the State)	B2 (-3) / B+ (-4)
Refer (owner of the railways: 100% of the State)	B2 (-3) / B- (-6)
Metropolitano de Lisboa (Lisbon metro: 100% of the State) - / B+ (-4)	
Parública (100% of the State and with its debt guaranteed by the State in the Decree-Law of its Statutes)	B1 (-4) / BB (-2)
RTP (TV public service 100 % of the State)	B1 (-4) / -

In some of these cases the Portuguese State is already paying debts of these companies.

Rating methodologies of American CRA exclude the possibility of any part of a Residential Mortgage-Backed Security of Home Equity Loans in Portugal having a AAA rating due to the rating of the Portuguese Republic.

Nothing of this is guaranteed in article 3.

4) Article 3 (1) (c) assumes that CRAs rely heavily on models, which may not happen. In fact, it mostly should not happen. Heavily relying on models is typical of scorings companies, not of CRAs. CRAs may use some models to treat data, but most part of the analysis should be qualitative in nature, to understand the generation of the cash flows of the issuer, and not automatic, through models, that so bad results gave these last few years (sub prime was just an example of what models can produce). CRA want to have an idea of what will be the film of the future of the issuer and not the photograph of its past through a model.

5) Articles 3 (2) e (3): ask for enormous detail, with:

- enormous costs;
- significant impact in competitiveness in the rating industry: as it is recognized in paragraph 36 of the Impact Assessment and when it admits "high short term costs for CRA" = "high entry barriers", which will never enhance the competition among CRA, as mentioned in paragraph 43 of the Impact Assessment; this will mean regulatory capital holdings based on worst quality ratings, higher price of raising capital (as issuers will be dependent on a few oligopolistic CRAs), higher prices to investors (that will end up paying the prices paid by the issuers), higher risks to the financial markets, as there will be no other CRAs as alternatives; none of these are included in the Impact Assessment;



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- a significant impact in turning the rating process so rigid that it may not be able to take in consideration relevant aspects not detailed in the methodology, because this one is too detailed, as it is recognized in paragraph 35 of the Impact Assessment.

6) Article 6 (5) (b) seems to be talking about scoring agencies when it mentions “in sample and out-of-sample testing”. It simply cannot be implemented in CRAs methodologies.

The focus should be on the quality of public reports, in the obligation of its free and systematic publication, and in incentives to investors to incorporate them in their analysis.

Ref. 4: ESMA's Draft Regulatory Technical Standards on the content and format of ratings data periodic reporting to be submitted from credit rating agencies

1) Again in these regulatory technical standards it should be taken in consideration that ratings are not only the symbols, but also the outlooks and the fundamentals for their attribution. The monthly report should request CRAs to send to ESMA copies of the press releases and public rating reports.

2) For what has been mentioned before, the monthly report should include, for each action, the request of the amount on any revenue received from the same issuer or related entities not related to rating actions in the previous (say) five or ten years to understand any kind of conflicts of interest that might exist in such a case.

3) Many of the standards defined in these regulatory technical standards are different, including periodicity, from the ones of CEREP, which involves a duplication of costs to CRAs. If all this data is necessary for ESMA monthly, it would be much better to have it incorporated in the CEREP and change the CEREP periodicity of reporting to monthly. This way there would only be one process of data collecting and data sending, instead of two.

If this is not possible, at least the fields should have the same Description, Type and Standard in both databases, which is not the case in many of them. This was recognized in paragraph 20 of the Impact Assessment: “in general CRAs have highlighted concerns regarding the risk of duplication of the obligations which they have to fulfill in respect of reporting to the Central Repository (CeRep) established by ESMA (...)”, but apparently the duplications and inconsistencies increased profoundly since the previous consultation.

These duplications are fixed costs and, as such, penalize especially smaller CRA (even if costs increase with the size of the CRA, as mentioned in paragraphs 28 and 30, it is also obvious from these



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paragraphs that they increase less than the increase in size of the CRA, being not proportional. As such, not helping the competitiveness in the rating industry and could very well be avoided (as stated above). The principle of proportionality should apply: for instance, smaller CRAs could report only quarterly instead of monthly.

On the questions asked:

Q2 For what was mentioned before, we also think it would be useful to request the amount on any revenue received from the same issuer or related entities not related to rating actions in the previous (say) five or ten years to understand any kind of conflicts of interest that might exist in such a case. (Real) example: American CRAs are rating Portuguese banks to which they sold internal rating systems. There should also be sent to ESMA a copy of the press releases with the main reasons for every rating action and a copy of the public rating report.

Q7 The expression “and the action type reported is different from ‘NR’” in the Type of field 15 does not seem to make sense.

There is a typing error in the Type field 19: it should read “(...) or in the first time” instead of “or the the first time”.

In Description of fields 30 and 31 it is mentioned that “if the action is subject to publication”. It should be said that under article 4 (2) of the Regulation only issued ratings (i.e., published ratings or distributed by subscription) are subject to the Regulation. So, it does not make sense to mention “if the action is subject to publication”, for if it is not subject to publication it is not even subject to the Regulation or to ESMA supervision.

In the Standard of field 35 it should be possible to use “INT” if ISIN and CUSIP are unknown by the CRA at the time of the action validity date.

It should be clarified if field 38 also applies to ratings other than structured, as it was not applicable in the case of CEREP.

In the Standard of field 39 it should be possible to use “ITR” if BIC is unknown by the CRA at the time of the action validity date.

It makes no sense to have identifiers in Description of fields 41 and 44 different from the ones already used in CEREP: it is a duplication of identifiers that will only cause confusion.

Q8 Many of the standards are different, including periodicity, from the ones of CEREP, which involves a duplication of costs to CRAs. If all this data is necessary for ESMA monthly, it would be much better to have it incorporated in the CEREP and change the CEREP periodicity of reporting to monthly. This way there would only be one process of data collecting and data sending, instead of two. If this is not



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possible, at least the fields should have the same Description, Type and Standard in both data bases, to avoid confusions (see Q2 and Q11, for example).

Q9 Some of the additional actions included in field 8 of Table 2 have to be cumulative (ex: 1: OT + NR, UP, DG or AF; ex 2: DF + DG or WD)

Q10 It does not make sense to publish that a rating is under observation because of a departure of a rating analyst to an issuer, because a rating analyst has a low weight in the attribution of a rating and that is immediately assuming ahead of the analysis that there was a misconduct, when the principle should be the opposite

Q11 It does not make sense to have identifiers different from the ones used in CEREP: it is a duplication of identifiers that will only cause confusion.

Q14 1 to 5

Q15 CPR would require a special IT program to deal with the data in the envisage format and would have to train someone to collect and send the data every month.

Q16 Positive view. Yes.

Q17 No. CPR does not use “watches”.

Q18 This will increase the number of actions to be reported every month, involving additional costs in collecting them (probably tripling the previously estimated cost of one man hour per month).

Q19 Yes for the first and third questions.

Q22 Yes: it is recognized in paragraph 20 that “in general CRAs have highlighted concerns regarding the risk of duplication of the obligations which they have to fulfill in respect of reporting to the Central Repository (CeRep) established by ESMA (...)”, but apparently the duplications and inconsistencies increased profoundly since the previous consultation.

These duplications are fixed costs and, as such, penalize especially smaller CRA (even if costs increase with the size of the CRA, as mentioned in paragraphs 28 and 30, it is also obvious from these paragraphs that they increase less than the increase in size of the CRA, being not proportional. As such, not helping the competitiveness in the rating industry and could very well be avoided (as stated above). The principle of proportionality should apply: for instance, smaller CRAs could report only quarterly instead of monthly.