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BBA RESPONSE TO CESR TECHNICAL ADVICE ON POSSIBLE MEASURES CONCERNING CREDIT RATING AGENCIES. SUBMISSION DATE 1st FEBRUARY 2005.

The British Bankers' Association represents more than 260 banks carrying on business in the United Kingdom. The majority of these banks come from outside the United Kingdom and our members cover the whole range of investment services.

In summary, the BBA supports policy option 6 outlined in the consultation paper, that of monitoring market developments within a framework of CRAs implementing the IOSCO code on a self regulatory basis. The provisions of the IOSCO code provide a rigorous framework of high standards and transparency.

The BBA can speak only for the banks it represents; however the majority of the financial services industry (not just banks under the aegis of the BBA) appears to have a common reaction to the prospect of regulation. This is in spite of the fact that firms might on the surface appear likely to have varying (even potentially conflicting) interests in the activities of CRAs. Large houses may include business areas on the 'buy' side, the 'sell' side and straddling the 'buy' and 'sell' sides. As such, banks are not putting forward an agenda of self-regulation for CRAs as a single interest group but rather as part of a majority consensus with the financial community.

Our members have raised the following key concerns and suggestions we would like to bring to CESR's attention:

1. Unsolicited Ratings:
    a. Our members believe that unsolicited ratings are a vital tool for new CRAs to build market share and help in overcoming the barriers to entry in this market. CRAs should continue to be able to use unsolicited ratings in an unrestricted fashion.
    b. A clear set of rating symbol modifiers should be used by the CRAs to make it explicit the level of co-operation of the issuer in collating an unsolicited rating.

2. CESR should not seek to regulate the use of ratings triggers in private contracts or require the disclosure of their use. This is an issue that should be left to the market to adjudicate.

3. The widespread use of ratings in European legislation is not supported.

4. If a registration scheme is put into place for CRAs, it should not be accompanied with stringent regulations. This will not aid competition in the ratings market.

5. The provision of ancillary services by CRAs should continue to be allowed within the framework of appropriate conflicts of interests provisions outlined by the IOSCO code.

6. BBA members do not support the proposal to regulate the skills and qualifications of rating analysts. CRAs should be free to select staff as they see fit. There are strong incentives for CRAs to employ the most experienced and highly qualified staff possible. There is no need for extra regulation in this area.

7. Methodology should be a purely market driven process. Intervention by regulators could reduce the confidence investors have in the independence of rating agencies. It will slow down the rating process and innovation in methodologies. There will be significant cost to maintaining sufficient numbers of staff at the regulator with appropriate skills and experience to adequately judge whether the methodology is good quality.

8. Right of appeal: issuers should not have a right of appeal on their ratings. Having a right of appeal implies that there will be a body for the issuer to appeal to. We would not support the creation of such a body. The issuer will already have been given the opportunity to object and or discuss the probable outcome during the ratings process. Ratings are ultimately the opinion of a private entity and it is crucial the CRAs are able to function independently.

We welcome the opportunity to respond to this CESR consultation on behalf of our members. We would be happy to discuss with CESR any questions arising from our response.

Yours faithfully,

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<u>CRAs DEFINITIONS AND USE OF RATINGS:</u>

(P15 CP)

Q.1. Do you agree with the definition of credit rating agencies? If not, please state your reasons.

Yes we agree with the IOSCO definition outlined in the CESR paper.

2. Do you agree with the definition of credit ratings? If not, please state your reasons.

Yes we agree.

Q.3. Do you agree with the definition of unsolicited ratings? If not, please state your reasons.

No. The concept of 'initiative' is too vague. How would this be defined or judged? It would be preferable to define a solicited rating and then move everything else into the unsolicited category. The key issue here is payment. If an issuer pays for a rating on themselves, this is a solicited rating. The general market model of the ratings business is that the issuer pays for the rating up front and those ratings are then free to view by all parties. Payment represents a crisp, clean, succinct way to define why the rating is in existence.

The definition of unsolicited ratings in this context is closely tied with three issues: the impression of them being a positive or negative thing. What an unsolicited rating implies about the quality of the rating. Finally presumptions about use of ratings by investors.

Unsolicited ratings are crucial for new CRAs to help overcome barriers to entry and promote competition. In this light, unsolicited ratings are a positive thing and it is unnecessary to precisely define them with a view to restricting their use.

The industry already has a clear view of the distinction between unsolicited and solicited ratings. Solicited ratings are paid for by the rated entity and are produced with full co-operation. Unsolicited ratings are not paid for by the rated entity and are therefore likely to be based on potentially commensurately lower quantity and quality of information.

The presumption that investors blindly follow ratings in their investment decisions is flawed. Ratings are only an opinion of credit quality based on established and published methodologies. Investors use ratings as part of a blend of factors which determine decisions. This addresses the question of a CRA assigning an unsolicited rating on an entity, which an investor then decides to use as the basis of its portfolio decisions. If that investor then makes losses, there is a presumption in some quarters that this is the Rating Agency's 'fault'. This is a misnomer. There is a market discipline in place, investors will arbitrage

off incorrect ratings and there will be a commensurate impact on that Rating Agency's reputation.

As long as there is a clear demarcation between solicited and unsolicited ratings there should be no fundamental issue with unsolicited ratings. That is, unsolicited ratings should be given a modifier symbol and there should be freely available information on CRAs websites outlining how unsolicited ratings are produced.

For the purposes of investor information, the unsolicited rating should carry a modifier to show it is unsolicited. These modifiers should have three distinct categories: e.g (Z1, Z2, Z3)

1. **Full co-operation with the CRA including access to privileged information.**
2. **Partial co-operation.**
3. **No co-operation by the issuer.**

There should be clear explanations of these three different levels of unsolicited rating on the rating agency's website. In this way investors will be more fully informed on what basis the unsolicited rating was determined.

Examples of unsolicited ratings:

a. The CRA decides to assign ratings based on public information to an entity on its own initiative for the purposes of market coverage. The issuer may then decide to provide some co-operation to the rating agency. This would imply a result of 'Rating.Z2' – implying partial co-operation by the issuer.

b. Similarly if an issuer decided not to co-operate with an unsolicited rating in any fashion, this would produce an outcome of 'Rating.Z3'.

c. If a third party pays for a rating on an unrated issuer. Again the rated issuer may or may not choose to co-operate in some fashion but the rating remains unsolicited. It is likely that this rating will be private and available only to the third party who paid for it anyway.

4. Do you think that issuers should disclose rating triggers included in private financial contracts?

CESR should not regulate the nature and use of ratings triggers in private contracts, nor should there be any disclosure requirement.

5. Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.

No. The widespread use of ratings in European legislation beyond the capital requirements framework is not considered to be advantageous. The use of ratings in legislation may serve to create additional costs to operating within the

EU in the context of the global market. We would not preclude all use of ratings and support CESR's proposition that a rigorous cost benefit analysis is carried out on a case by case basis. Where they are utilized we would suggest that ratings are not used in a binary, (yes/no) fashion but rather they are used to provide gradations of intent. That is, the attainment (or loss) of a certain rating level should not define inclusion or exclusion from an approved list.

COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY:

(P19 CP)

1. Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?

The ratings market is a reputation based business. Therefore there are naturally going to be significant barriers to entry. The issues are: a.) is this significant? And b.) to what extent can the EU constructively regulate to improve this situation?

a.) The key is that this is a reputation based industry and that whilst it is extremely difficult for new CRAs to enter the market and build up a reputation, it is quite easy for existing participants to lose their reputation for quality. This exerts a strong discipline on CRAs and they have every incentive to act to the highest standards of probity and rating quality. We would suggest that it is not significant that there are a limited number of CRAs in the EU.

b.) We believe that it will be difficult to create regulation that will open the market in a constructive fashion. Simply creating a registration scheme for CRAs will not in and of itself resolve this issue. In fact it will certainly create three detrimental effects that have to be balanced against any positive gain when considering this proposal:

1. **The cost to new, smaller CRAs of conforming to rules in order to be registered are likely to be a much more significant percentage of revenue than to the established players.**

2. **The registration of new CRAs could imply an element of 'endorsement' from the regulator which may not be desirable. It is likely that the retail investor, who is likely to have much less information than a wholesale participant, may view registration as a mark of quality of the ratings themselves rather than the procedures and structures of the rating agency. It is this retail investor who is likely to require the most protection from the regulating authority when it comes to dealing with rating agencies.**

3. **Any extra costs of conforming to these regulations for registration, (compliance staff, training etc) are likely to be passed in the most part on to issuers.**

Merely creating a registration scheme will not overcome the reputation barriers to entry that exist in this market. It is only if certain financial instruments are required to have a rating by one of the new participants that this registration will have a significant effect. That kind of policy would have significant moral hazard issues.

It is much preferable that CRAs compete on price, service and quality of ratings, as Fitch have successfully done in the past five years to expand their market share. Rather than being a cost to issuers, this form of competition improves their economic outcome.

2. Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?

We believe that the ratings coverage of SMEs should be driven by the market. If sufficient demand for ratings was in evidence then there would be greater coverage. SMEs often get funding in a bilateral relationship with a bank that does not require a public rating.

RULES OF CONDUCT DIMENSION:

(P24 CP)

1. To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

We agree with CESR's proposal that CRAs should develop strong policies and procedures for management and disclosure of conflicts of interest. CRAs should attest that ratings have been formulated within the framework of the IOSCO code. CRAs should take all reasonable steps to avoid conflicts of interest in the ratings process.

2. Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?

The provision of ancillary services by CRAs represent a vital service to the market. CESR should not prohibit CRAs from carrying out the value adding ancillary services within an appropriate environment of managing conflicts of interest. The IOSCO code contains stringent provisions on ancillary services that CRAs will be obliged to adhere to. No further regulation is necessary.

3. Do you think that structured finance ratings give raise to specific conflicts of interest that should be addressed in CESR's advice to the Commission?

No.

4. To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?

CRAs should have robust conflict of interest measures in place in relation to ancillary services, e.g Chinese walls etc. The objective of delivering independent, objective and high quality ratings in which users have confidence should remain the primary goal of CRAs and sufficient measures should be put in place so as not to compromise this objective by providing ancillary services.

5. To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?

We believe this issue is sufficiently addressed by the disclosure of solicited and unsolicited ratings. Full transparency of CRAs fee schedules would not produce an optimal outcome.

6. In order to deal with issues related to unsolicited ratings, to what extent do you agree that it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures with regard to issuing unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?

It would be sufficient to have CRAs clearly disclose which ratings are unsolicited. As outlined previously, unsolicited ratings should be given a modifier symbol to show the level of co-operation of the issuer in producing the rating.

7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investments being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?

See answer to Q5.

FAIR PRESENTATION:

(P28 CP)

1. To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?

We do not agree with the proposal of regulating the skills and qualifications of staff at CRAs. The IOSCO code already contains several provisions regarding the nature and extent of staff qualifications and experience. The HR policies of CRAs should be market driven. Rating Agencies' first and foremost driver is to continue to produce high quality ratings. Therefore there is every incentive for CRAs to employ the most experienced and highest qualified staff possible. Rating Agencies should have the choice to employ whomsoever they think provides the appropriate blend of skills, experience and personality to fill a post. Creating official requirements for rating analysts could potentially create bottlenecks in supply of staff and raise costs. This is likely to impact most heavily on new rating agencies trying to build up their teams.

2. Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessments?

As outlined in our answer to question 1. We strongly advocate there being no regulation on human resourcing issues for CRAs.

3. Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?

No. We believe that there is adequate disclosure of methodologies. There are strong incentives for CRAs to outline their methodologies to interested parties. CRAs often disseminate their methodologies into the market for free, in order to increase their transparency and aid investor understanding. They should not be forced to disclose methodology free of charge to all in the same way that the ratings themselves are disclosed. The IOSCO code contains provisions on the disclosure of methodologies that would sufficiently cover this issue.

4. Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and which is the best way of dealing with them. Do

you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?

We see no advantage in regulators becoming involved in rating agency methodology. This should be a purely market driven process. Intervention by regulators could reduce the confidence investors have in the independence of rating agencies. It will slow down the rating process and innovation in methodologies. There will be significant cost to maintaining sufficient numbers of staff at the regulator with appropriate skills and experience to adequately judge whether the methodology is good quality. This cost will continue to escalate if the number of CRAs in the market increases.

The judgment on the quality of rating methodologies should be made by the investor.

Different CRAs have different basis for their methodology. Therefore the regulator would have to assess not just one but at least two or three different methodologies for each type of rating.

There is also a systematic danger to standardizing methodologies across rating agencies. A variety of approaches provides the market with differing responses to market events rather than all the ratings 'dropping off a cliff' at the same time.

5. Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?

We agree with the main provisions of the IOSCO code and consider them sufficient on disclosure within an environment of self regulation by rating agencies.

Where there are fundamental changes to rating methodologies it may be appropriate for CRAs to give some advance disclosure to issuers. However this should be a device used very sparingly. Rating agencies should be given extensive leeway in deciding which methodology changes should be pre-announced.

6. Do you believe that regulation should concern all aspects of CRAS' methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by self-regulation?

As outlined in our answers to previous questions we do not believe that the regulator should become involved in the rating methodology process.

Ratings should be updated on a timely basis and should reflect all current information. CRAs should publish written reviews on an appropriate periodic

basis for all ratings, as outlined in the IOSCO code. This would give confidence to the investor that the rating reflects current information and market conditions.

RELATIONSHIP BETWEEN ISSUERS AND RATING AGENCIES:

(P36 CP)

1. Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issue of access to inside information by CRAs?

Yes.

2. What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instruments?

The issuer should not have to disclose to the market that they are aware of an imminent rating change. This issue is dealt with via CRAs in an efficient manner, in that they would normally give only very short notice, (intra day) of a rating change.

3. Do you consider that the requirements of the Market Abuse Directive in this area sufficiently address the risks that inside information might be disseminated, disclosed, or otherwise misused?

Yes.

4. Are there any other issues concerning access to inside information which CESR should consider from the perspective of establishing a level playing field between CRAs?

No.

5. Are there any other issues concerning the Market Abuse Directive's provisions concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?

No.

6. Do you consider that it would be helpful to have a dedicated regime governing CRAs and their access to inside information?

No. We consider a dedicated regime unnecessary as they are adequately covered by the Market Abuse Directive.

7. Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?

The current provisions in the Market Abuse Directive and the IOSCO code are sufficient.

8. In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRAs opinion?

No. The concept of a right of appeal is a misnomer. In order to be able to appeal there has to be a body to appeal to. We do not support the establishment of a supranational appeals body for ratings. The assignment of a rating is a process, (usually over a number of weeks or months) rather than a one time, black box analysis. The issuer will have been given an indication of the likely rating outcome before ratings are assigned. Therefore the issuer will have already had the opportunity to object to the rating levels. Ultimately ratings are an opinion of a private entity. If the issuer has objections to the rating then there is no obligation to go forwards with it. It is a lynch pin of rating agencies activity that they can function independently.

Most issuers have multiple CRAs providing ratings; therefore the market discipline creates a strong incentive for CRA to produce the most accurate ratings possible. If the ratings of two different agencies on the same issuer are significantly different there will be market pressure on that rating.

9. Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?

Yes. A combination of self regulation of the IOSCO code and market discipline will be sufficient to ensure information published by CRAs is accurate.

10. Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?

All appropriate documents, legal, methodologies, communication with the issuer etc should be retained by the CRA for a minimum period. Section 1.5 of the IOSCO code sets out a requirement to retain appropriate documents to support credit opinions for a reasonable period of time.

11. Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?

No. We believe that the creation of a 'data room' would add more to costs than it would provide benefits.

REGULATORY OPTIONS CONCERNING REGISTRATION AND RULES OF CONDUCT FOR CREDIT RATING AGENCIES:

(P43 CP)

1. Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:
- A full registration/regulation regime based upon detailed criteria;
- A lighter registration/regulation regime essentially based upon the IOSCO Code;
- To assess compliance to IOSCO Code Fundamentals in a parallel process to CRDs recognition;
- A third party's certification or enforcement of the IOSCO Code;
- Relying upon rules covering only specific aspects of CRAs' activity;
- Monitoring the market developments.

See our response to Q.2

2. Could you please indicate your preferred option and highlight pros and cons that you see with regard to each policy option?

We would strongly support Option 6, that is, to give the IOSCO code of conduct an opportunity to increase transparency and competition through self regulation on a comply or explain basis. This always leaves open the possibility that further action could be taken at a later date if these goals are not demonstrably being met.

3. Do you think the IOSCO Code of Conduct is conducive to reducing or increasing competition?

The self regulation and the IOSCO code represents a useful way forwards in creating an opportunity for increased competition of new entrants and between existing CRAs whilst effectively balancing the need to continue to provide high quality independent ratings.

4. Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?

No.

5. To what extent is a joint treatment of rating agencies by banking and securities regulators desirable?

We do not believe it is necessary to specifically regulate CRAs. However in the event that they are covered by a regulator it should be the established national bodies, such as the FSA. Consistency of regulation is vital to the efficient functioning of capital markets.