

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

The BBA and LIBA welcome this opportunity to comment on CESR's consultation on the role of rating agencies in structured finance.

The BBA is the leading association for the UK banking and financial services sector, speaking for 228 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

LIBA is a principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its Members on all aspects of their business – both international and domestic – and promotes their views to the authorities in the United Kingdom, the European Union and elsewhere.

In the first section of this response we set out our key messages, the answers to the specific questions raised are included in Annex 1.

Executive summary

CRAs will and should continue to play a key role in capital markets because ratings are a necessary input. Ratings of structured products have contributed enormously to increased credit availability and a wider, more effective distribution of risks and rewards.

Ratings however, are not a substitute for investors' own risk assessment and CRAs should not be held responsible for inappropriate decisions by investors. At the same time, the financial market turbulence and the perceived failure by CRAs to give sufficient early warning of the problems in structured finance vehicles have demonstrated the need to assess CRAs practices with a view to restoring market confidence in the rating process. In making this assessment, it should be noted that the role of CRAs is limited. CRAs provide opinions on credit risk, not pricing or liquidity and they should not to be held responsible for these other issues.

Investors do discriminate between issuers and securities with the same rating but which are perceived to be of different quality, and this is demonstrated by differing market prices (although of course such price differentials can also be partly attributable to factors other than perceived credit quality). We therefore think that it is appropriate to provide additional information regarding the potential volatility of the ratings, as this would enhance investor understanding. However, our members do not think that it is appropriate to have a separate rating scale

CRAs must address firmly and transparently any conflicts of interest which may influence their ratings by improving their governance and practices. They should also make their concepts, models and working methods more transparent so that investors can understand better the risks associated with structured products and the limitations of ratings.

In addressing these issues, CESR, national regulators and policy makers are encouraged to support solutions that can be effective internationally. For that, regulation, formal or informal, should be mutually recognised and/or harmonised at global level. The current supervisory monitoring of CRA which ensures the eligibility of their ratings for regulatory capital purposes under Basel II/CRD is welcome.

We do not support steps toward formal, direct regulation of CRAs. An enhanced IOSCO's "Code of Conduct" and strengthened internal controls are more effective responses.

Please find our answers to the specific questions in the annex to this letter. We welcome the continuation of the valuable dialogue that has been created between CESR and the industry on CRAs. We look forward to continuing to work with CESR on this issue. If you have further questions, please do not hesitate to contact either Diane Hilleard or myself.

Yours faithfully,



Ross Barrett
British Bankers Association



Diane Hilleard
London Investment Bankers Association

ANNEX I:

1. TRANSPARENCY:

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

We broadly agree with CESR's sentiments, but the agencies have already taken some reasonable steps in this regard. A major issue surrounds tail/volatility risk, which does vary from one product to another within the broad spectrum that constitutes structured finance. The volatility of ratings for prime UK RMBS is much lower than some more leveraged transactions. We, therefore, do not support the imposition of a different ratings scale for structured finance. Such an approach would not necessarily enhance investor understanding and would potentially discourage the re-establishment of the structured finance market. We consider that the meaning of a particular rating should be consistent across asset classes, as far as possible.

Credit Rating Agencies (CRAs) should do more to communicate to potential users the nature and remit of what their rating addresses. We would envisage something (as CESR suggests) that would be more than simply an extensive legal disclaimer. In line with our comments above our members would welcome much greater clarity on the potential volatility of ratings and the factors that may trigger these changes. Whilst we would welcome greater discussion of market volatility and its impact on ratings, it should remain the case that ratings are solely opinions on the credit risk based on an assessment of probability of default. Whilst it may be helpful to include more commentary on market volatility, it should not actually be factored into the rating.

Investors must take a significant role in assessing whether these structured finance instruments are suitable for their portfolio. This is particularly apposite as the overwhelming majority of investors in these instruments would be classified as professional in line with client categorisation rules under MiFID. Clearly however, CRAs have a responsibility, (given their charging structure) for disclosure and, if necessary, investor education, on the nature and complexities of these instruments. Perhaps more could be done in the form of free seminars as opposed to the current paid for seminars run by CRAs which are an ancillary service and profit line for CRAs. This would enable much wider dissemination of the central characteristics, modalities and limitations of structured finance products & their ratings to investors.

We support CESR's view that external ratings cannot and should not replace investors' own risk assessment. However, it is not possible to impose the entire burden for establishing appropriate investor behaviour on the rating agencies. CRAs can ensure that they provide sufficient information for investors to use their opinions sensibly but investors have to take responsibility for their decisions and make sure that they have appropriate systems and controls in place.

To mitigate against inappropriate reliance on ratings, CRAs should articulate clearly the objectives, the factors that they take into account and the resulting limitations of their ratings. We think such an approach will reduce the risk that investors will continue to misread ratings and use them as a proxy for assessing all risks (market, liquidity etc.) rather than just default risk.

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?

We support CESR's analysis regarding the transparency of rating methodologies. Website usability has been a significant issue for our members and we would like to see further strides made by CRAs in this area.

Greater clarity of assumptions and correlations in both new issue reports and monitoring reports would improve investors' ability to 'look through' the transaction rating to the underlying asset pool quality. CRAs have also changed their structured finance methodologies. The market perceives that these changes have been accompanied by differing levels of protection for the same rating grade. There is no simple way for investors in the secondary market to know which methodology has been used for rating a given transaction.

Our members would welcome much more transparency on the potential volatility of the ratings themselves and the factors that might initiate such changes. This transparency should be applied across all rated sectors. It would be very useful if CRAs were to outline potential scenarios where major assumptions were broken e.g. Downgrading of a monoline insurer and the resultant impact it would bring on the rating.

We agree with CESR that it would seem inappropriate for CRAs to develop a separate, fee paying service to aid investors understanding of ratings. It is in everyone's interest that any current perceived opacity in the structured finance market is improved and the CRAs should take their share of the burden for improving the situation.

Investors agree that relevant transaction information is available but only on the basis of a costly subscription. Likewise many of the longer-term volatility studies (which are crucial to understanding the risk around the straight ratings) are only available with expensive subscriptions which put them out of reach of all but the largest investors.

Transparency is key to help investors understand ratings. Although CRAs make their methodologies available, investors are often unable to properly assess the ratings in the absence of information about the underlying exposures, stress testing and assumptions of methodology.

CRAs need to make the assumptions of their methodology, their working methods and their stress testing better documented and more transparent to investors. The “look-through” approach to the underlying exposures should be consistently applied and disclosed.

To help investors to judge the impact of potential market disruption, CRAs should provide additional information associated with their ratings on attributes related to credit risk assessment such as ratings volatility and migration risk. This additional information should be applied across all rated sectors.

We would however, point out that ratings are forward looking and therefore probabilistic in nature and cannot be proved right or wrong until after the event. In short, if an asset does not default even this does not indicate the rating was 'right' just that the asset didn't default. It is not appropriate that CRAs should be held responsible for actual asset defaults, merely to provide an opinion on the likely risk of this occurring on the basis of the information available. . The onus is on investors to hold onto this definition of risk and to invest in the clear knowledge that ratings indicate a risk probability not a right or wrong assessment of whether an asset will lose money.

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?

We agree that it would benefit investors and the wider market as a whole if CRAs were to clarify, for a given rating which evolution of the relevant methodology was used to determine this rating. This additional clarity would enable investors to better judge the specific assumptions and risk factors that relate to their transactions. Market discipline would also be enhanced as investors would likely request rating agencies to re-evaluate older deals on the basis of newer methodology. This would have a two-fold benefit of making ratings much more comparable and create an environment where many more regular forensic, ground-up reviews of transactions were carried out by the rating agencies. In particular, greater transparency is welcome where rating reviews are the result of changes in rating methodology. We recommend that the CRAs dedicate sections of their websites to the methodologies of various products and their evolution over time.

Whilst it would be beneficial for the markets to be confident of which iterations of methodologies were used in assessing different securities. We would note that this would not be a panacea because in many credit analyses multiple criteria can, and will, be validly applied to the credit assessment.

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?

We would support the development and provision of appropriate forms of standard minimum information in performance of underlying assets. Such

information would allow investors the ability to reach through the rating to the underlying performance,

However there are still numerous issues (such as details of particular deals being available only to those who bought at new issue, which discourages secondary market-making from other places and makes life difficult for bondholders generally). One of the reasons investors may not have been fully aware of the differences between corporate and structured AAAs is that the rating agency reports on such topics are available by subscription only.

Clear definitions and improved disclosure will improve marketability and help restore confidence in structured products. The industry in the EU is already undertaking a number of initiatives to improve disclosure and transparency for securitisation transactions, including a work stream that is considering definitions across jurisdictions. Examples include CMBS and RMBS reporting. It is important that both regulators and industry work together at a global level to ensure that these, and other initiatives relating to recent market events, are effective.

2. MONITORING:

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?

We agree. Markets want timely, forward-looking, new performance information arising from CRAs monitoring of their ratings. Contractually required announcements which just re-confirm the status quo are less beneficial.

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 monitoring of complex structured finance transactions, especially CDOs (in their many derivative formats) is a key area of concern for the industry. We welcome CESR's ongoing focus on this issue. We share CESR's concern about the resource allocated to monitoring on an ongoing basis and CRA's ability to deal with spikes in the volume of rating reviews. This is particularly pertinent as many of the CDOs, themselves contain other CDOs. Therefore unpicking the impact of a major exogenous event can be a long and complex process involving hundreds or even possibly thousands of separately rated transactions.

It is important that CRAs allocate sufficient and capable resources to oversee and monitor the ratings of complex transactions. As already noted, CRAs could provide additional ratings information on attributes such as ratings volatility and migration risk, which need to be monitored continuously. The industry will also

welcome the implementation by CRAs of benchmark standards for turning around requests for ratings.

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?

The impression in the market is that there have been significant levels of staff turnover at CRAs and this has raised questions not only about monitoring quality but also of assignment of new ratings. Our members would like to see the management of CRAs to be much more proactive in putting resources into monitoring structured finance ratings. This should manifest itself in both the number and seniority of staff engaged in this activity. We would support a move away from a narrow reliance on purely quantitative tracking of arbitrary triggers in the transaction by junior staff and more emphasis on regular qualitative analysis by more senior analysts to maintain ratings quality over time.

A key concern among investors and the official sector is the perceived failure by CRAs to give sufficient early warning of the problems in structured finance vehicles. We think that this indicates that the human capital that is allocated to rating and monitoring structured finance securities could be strengthened.

That being said, the structured finance market in Europe has experienced double digit growth, and thus, it is fair to say that it has been a challenge for all stakeholders in this market to resource for such high growth rates. The availability of technically qualified and experienced staff for the most complex of structured finance products has been a problem not just for CRAs, but also other financial institutions (for instance, issuers and arrangers).

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?

No. The human resources issues should be left to the market. We do not consider that arbitrarily setting educational requirements would significantly add to the quality of the ratings outcome. Experience, tenure and range of knowledge are all factors that are as important as academic qualifications. We would not support the introduction of a 'Rating Analyst' qualification that has been mooted by some parties.

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

We fully support CESR's suggested approach of greater transparency in CRA resourcing. The market would welcome additional (anonymised) information on staff turnover at different levels within each CRA.

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

Yes we agree. We would support CESR's drive to shed additional light on analyst remuneration policies and the CRA relationship with issuers. This is a central aspect of CESR's work in this area.

CRAs remuneration practices should not contribute to perceived conflicts of interest. Incentives issues could be addressed through internal governance rather than by prescribing specific remuneration structures.

3. CONFLICTS OF INTEREST

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?

We agree with CESR's proposal that CRAs should ensure that they are fully transparent with regard to the exact nature of their interaction with issuers/arrangers of structured finance products. They should also ensure they have strong policies and procedures in place to monitor and control this interaction and ensure it reflects their public position.

An updating of the IOSCO Code for CRAs to provide greater clarity and act as a benchmark of acceptable practice for CRA interaction with issuers represents the appropriate way forward. CRAs must ensure that they are appropriately structured to deal with strong cross currents of conflicts that occur during the rating and monitoring process. These provisions could mirror the *conduct of business* and *systems & controls* rules that banks are required to adhere to in order to manage their conflicts of interest.

It is the very nature of the rating process for structured products that it requires greater interaction between CRA and issuers compared to the rating process for more traditional securities such as government or corporate bonds. Increased interaction with arrangers and issuers of structured products should not, however, undermine CRA independence in the rating process and result in conflicts of interest. Active management of the risks for conflicts of interest should continue to be on CRA's agenda.

CESR should note that, it is common for the ratings process to involve the client requesting assessments of multiple possible structures where only marginal differences exist in the different structures. The CRA will feedback on each of these structures whereupon the client will choose the most appropriate structure from their point of view. This type of interaction does not constitute an advisory role and should be seen as a part of the normal process of interaction between CRA and client. Such interaction should be viewed as communication that leads to improved structures in order to achieve a desired rating, rather than that

compromises the quality of rating. It is important that such dialogue continues to occur otherwise it will become very difficult for issuers to bring transactions to market in a timely manner.

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?

Although we agree that CRAs should be transparent, our members are not overly concerned by this issue. In principle, the possibility of a conflict of interest is always there; in practice we would suggest that their reputation is too valuable for CRAs to consciously endanger it. Provided the individual analysts are not remunerated for quantity of deals done, this may be less of a problem than it initially might seem.

CRA procedures and practices in the rating process including interaction with arrangers, issuers or originators should become more transparent to investors.

CRA internal procedures and external practices should ensure that any interaction with arrangers, issuers or originators is not tantamount to performing an advisory role in the rating process which would be a source for conflicts of interest.

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

Yes, we would support an analysis of the distinction between core and ancillary business carried out by CRAs. However the outcome should be a policy that it is possible to interpret in a flexible fashion, to deal with future business lines / developments rather than straight-jacketing CRAs into a very narrow range of services. Nevertheless we would welcome greater transparency from CRAs and discussion of the potential conflicts involved as a result of providing ancillary services.

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?

Having a transaction-based fee model may create an incentive to get a transaction out of the door, but it ought not to mean that the rating ends up being lower than it should otherwise be. You could conceivably increase the proportion of the fee paid during the monitoring part of the process and/or a separate, later fee payment for monitoring after the up-front fee at the time of origination (implicitly raising the longer-term commitment to the transaction, as opposed to the emphasis on printing the deal), but it is difficult to see a viable alternative.

There is no fee model which will be problem-free or resolve all stakeholders' concerns. From a capital market perspective, what is important is that ratings

remain publicly available products comparable across geographies and asset classes.

To reduce conflicts of interest concerns and improve transparency, CRA fees for rating structured products should be clearly separate from the issuers' objective of attaining a target rating level.

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?

We agree with the general principle of greater disclosure of fee structures for structured finance deals. There are clearly issues in the opacity of fee structures within and between CRAs. This is partly because there is qualitative judgement involved in the rating work, not just mechanical quantitative rating assignments. The fees are designed to reflect this. It is not practical to remove the flexibility to accommodate the fees for the qualitative work. We therefore would encourage CESR to also review the vast disparity between 'success fees' for the initial rating and the ongoing monitoring fees, which creates eddies in the flow of incentives for CRAs.

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

Broadly yes, but think the benefits outweigh the negatives. The massive sell-off in the agencies' stock prices of late can be seen in many respects as a vindication of market discipline.

While ratings are used in part in CRD, many banks will rely on internal ratings, and it is not necessarily the case that market forces will not be as effective in future.

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

CESR must consider the impact on competition in the CRA market of any formal regulatory regime. Competition from Fitch helped to open the structured finance market, improving the levels of service and transparency. The burden and cost of any future possible regulatory environment must not be so high as to negate the possibility of any further CRAs gaining a significant foothold in the market. It would be an adverse outcome if the result of regulation designed to enhance the market for ratings, thereby precluded any further CRAs entering.

We consider there is a need to review the current regulatory regime of the CRA market. The IOSCO code itself should be appraised, together with the way in which it is enforced. In principle, we view the IOSCO code as a means to ensuring a balance between the need for maintaining appropriate industry standards, and the development of the market through new entrants. It would certainly not be a positive outcome if the result of this review were to be that any further CRAs become completely shut off from entering

the market, resulting in the stagnation of market competition, with no further enhancement.

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

We would favour maintenance of the current regime rather than imposing additional regulation, given discouragement that regulation would create to new entrants, and again, a general feeling that current conflict of interest concerns may be misunderstood. We think that formal regulation will discourage new entrants. The conflict of interest concerns can be addressed through the code, because although this is a risk that can not be removed from the system but can be managed. The agencies, made a mistake with CDOs of ABS, and they should be encouraged to be more transparent, but it seems unlikely that they consciously debased or misused ratings in the hope of doing extra business, and even less likely that they would consider such activity in future.

The effect of new regulations, such as the Basel II Accord/CRD, whilst not directly impacting the CRAs, does have ramifications for the wider sector and their ability to help maintain financial stability has not yet been assessed. We would suggest that where individual member regulators interact with CRAs to either recognise them for regulatory purposes or manage their activities these powers should be encourage prudent practice by CRAs.

In recent years there have been a number of additional regulations that will impact on CRAs and structured finance: The External Credit Assessment Institution (ECAI) status for Basel II/CRD; MiFID impact on Client Classification, Appropriateness, Suitability and what types of clients these products can be sold to; the Prospectus Directive and changes to the US Nationally Recognized Statistical Rating Organization (NSRSO) criteria all need time to for their impact to be fully realised. Due to the international nature of CRAs' business, it is important for CESR, national regulators and policy makers to consider CRAs' standards and any regulation of CRAs in a global context, which will involve regulatory coordination and mutual recognition. Therefore at this stage we would support a strengthening of the IOSCO code and regular review by IOSCO of CRAs adherence to it.