Exchange Expert Commission

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Comments of the Exchange Expert Commission on the CESR Consultation Paper on possible measures concerning credit rating agencies (CESR/04-612b)

Introduction

The Exchange Expert Commission (BSK) advises the German Federal Ministry for Finance on capital market policy issues. It consists of senior representatives of industry, banks, insurance companies, stock exchanges, investors, academia and Deutsche Bundesbank.

BSK welcomes the consultation started by CESR. The quality of credit ratings forms an essential factor contributing to investors' confidence in capital markets and in particular in companies listed at stock exchanges. In competing for investors' capital the quality of credit ratings is also an important tool for (listed) companies. Corporate scandals such as those associated with Enron and Parmalat have weakened the overall confidence since rating agencies failed to fulfil their function of providing an early warning system by downgrading the creditworthiness of companies before their situation deteriorated to an extent that a collapse became imminent.

While BSK believes that the detailed formulation of rules of conduct should better be left to the companies, investors and rating agencies themselves, we feel that there is one fundamental question underlying the debate that needs to be commented upon: the policy options for regulating Credit Rating Agencies (CRAs). It is directly addressed in part IV. of the CESR paper and BSK therefore focuses on this section of the text. BSK prefers not to analyse the various options proposed by CESR in detail, but would like to put forward arguments in favour of self-regulation and reliance on voluntary codes of conduct in dealing with CRAs.

The case for self-regulation on a global scale

Both CRAs and the institutional investors using their assessments operate on a global scale. The same is frequently true for companies seeking a rating. Measures aimed at regulating CRAs should therefore be global in scope as well. Any European or national special treatment of CRAs carries the risk of undermining international confidence in ratings carried out under such regimes.

On December 3, 2004, IOSCO agreed upon Code of Conduct (CoC) Fundamentals for CRAs that build upon earlier work. The IOSCO CoC Fundamentals have the advantage of being a compromise reached by regulators from all parts of the world, including the US and Europe, that differ in their attitudes towards investor protection and reliance on private standard setters. The CoC Fundamentals focus on transparency and voluntary self-regulation. A national or international enforcement of the CoC Fundamentals is, for the time being, neither foreseen nor recommended. A proposal made in the preamble of the draft CoC of October 2004 to establish a third party acting as an arbitration body to determine whether a CRA is in compliance with the CRA CoC Fundamentals was refused by the international regulators.

Dilemmas of external CRA regulation

The external regulation of CRAs, irrespective of whether it is carried out by a public, a semi-public or a private entity, faces a number of dilemmas.

First of all, it needs to be emphasized that regulation is only advisable in the case of market failure. Only in case of obvious misconduct by CRAs the responsible authorities should be informed. If CRAs repeatedly misbehave, additional regulatory measures should be considered. While some CRAs may have been late in revising ratings in the wake of corporate scandals it is questionable whether this has been due to market failure. Insofar as fraud on the part of the rated companies has played a role the necessary legislation is already in place. Although competition in the rating sector is limited, because reputation building through a long track record is a precondition for the economic success of CRAs, oligopolistic competition between the large CRAs still exists. Furthermore, there is also a great number of smaller CRAs that specialise in niches such as the rating of medium-sized companies and exert competitive pressure. Therefore, there is no strong case for market failure in the rating sector. This suggests that voluntary self-regulation should be preferred to external regulation.

Secondly, credit ratings have a direct impact on the cost of capital of companies and public authorities raising funds on the securities market, and serve as a benchmark for institutional investors in particular. Therefore, the protection of retail investors as a justification for regulation applies only to a limited degree.

Thirdly, external supervision might unduly politicise the decisions of a rating agency, since authorities and third-party arbitration bodies might be more susceptible to political pressure. Thus, the attempt to improve the quality of a rating by an external

regulation may backfire, undermining the confidence in ratings and rendering the rating process inflexible and bureaucratic.

As an alternative to regulation by a public authority, the establishment of an arbitration body for solving disputes between issuers and CRAs in order to improve fair presentation has been proposed by some. However, there is a trade-off between the objectives of fair presentation of an issuer and the efficient revision of a rating if new information about a rated company emerges. In the interest of fair presentation, issuers should be given the opportunity to correct misperceptions of company-specific factors, e.g., a company's risk-management system. On the other hand, the rating procedure must not degenerate into a bargaining process between CRA and rated company because this would harm the objectivity of a rating and might unduly delay the revision of ratings, the latter being one of the reasons why consultations to regulate the sector were started in the first place. Therefore, BSK fully embraces the decision taken by IOSCO against establishing such an arbitration body.

For these reasons, BSK argues at this point of time against external enforcement of CRA standards, be it via supranational or national authorities, or via third parties.

The preferred regulatory option: transparency rules and "comply or explain"

The best approach to regulating CRAs is to remove informational asymmetries and thus enable the market to pass its judgement on ratings. Such transparency rules concern the generation of concrete rating decisions, CRA's methodologies, sources of potential conflicts of interest, as well as the implementation of rules to uphold quality and integrity. The IOSCO CoC Fundamentals contain a comprehensive list of such measures.

In standard 4.1, IOSCO recommends disclosure of CRAs' internal codes of conduct, its implementation and its degree of accordance with the IOSCO CoC Fundamentals. This is equivalent to the first part of policy option 5. of the CESR document (see para. 187: "The CRAs should then disclose to regulators and to the market their degree of implementation of the Code"). This approach should be widened to a "comply or explain" rule, as laid down in the IOSCO CoC Fundamentals, which would additionally demand an explanation of deviations from the code.

A preference for self-regulation, however, does not imply a renunciation of external regulation once and for all. Should the disclosure-based compliance or market enforcement approach of IOSCO's CoC Fundamentals prove insufficient a more formal enforcement scheme can be worked out and implemented, preferably at an international and not only European level.

A further idea for increasing the transparency of the rating sector, which goes beyond the IOSCO CoC Fundamentals and which seems worth discussing, is the scoring of rating activities. While any evaluation of the quality of a CRA's methodology should be left to the market, transparency for users could be increased by measuring ex

post the accuracy of ratings and the time taken for revising ratings if new information emerges.

The Capital Requirements Directive and the need for registration

A related issue that has also been discussed in the CESR document is the registration of "External Credit Assessment Institutions" (ECAI) in the context of the forthcoming Capital Requirements Directive (CRD; see CESR document paras. 70-73, 109, 160-162, and 180-182).

Such a registration, however, should not be confused with a "regulation light" of CRAs. Its scope is strictly limited to the use of external ratings for the calculation of capital requirements. It still needs to be seen whether there will be a large overlap between ratings relevant for CRD/Basel II and the core competence of CRAs, since it is likely that internal assessments by banks will form the overwhelming part of ratings carried out under the auspices of the CRD. Nonetheless, making the implementation of the IOSCO CoC Fundamentals mandatory for CRD purposes will have some repercussions for the voluntary nature and the self-regulation of the CRA sector as a whole.

We are looking forward to the further discussion on CRA regulation and will gladly contribute to it if the need arises.

Frankfurt am Main, January 2005