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Fabrice Demarigny
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28 January, 2005

Dear Mr Demarigny

Response to CESR's technical advice to the European Commission on possible measures concerning credit rating agencies (CRAs") - Consultation Paper November 2004

The Bond Market Association's European office and its Credit Rating Agencies Working Group [1] welcome the opportunity to respond to this Consultation Paper.

We congratulate CESR for its generally thorough and thoughtful analysis of the various issues raised by the European Commission. Our comments follow the structure of CESR's Consultation Paper.

For your quick reference, we attach in Annex the detailed summary of our response which was submitted to the Chairman and Rapporteur of CESR's Task Force on CRAs on 21st January, 2005.

I. INTRODUCTION

Definitions

Q1. Do you agree with the definition of CRAs? If not, please state your reasons.

While we believe that CESR's focus on those entities whose main business is the issuance of ratings of debt securities and issuers is the correct approach for the purpose of this Consultation Paper, we do not think that CESR's definition should be adopted for the purpose of future EU regulation of CRAs. Any proposed definition of CRAs in

[1] The Bond Market Association is an international trade association representing investment firms and banks that underwrite, trade and distribute fixed income securities and other financial products globally. TBMA's CRA Working Group consists of European and global heads of Rating Advisory Services functions at investment firms which, between them, cover a significant proportion of new issues of rated debt in the European market. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.

the context of further regulation of CRAs would need to take account of the following.

First, it would need reconciling with the broader definition of CRAs in the the Iosco Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO Code"), which omits the word "primary" from its definition of CRAs. This, however, would raise the concern that investment firms'/banks' research departments may be covered by the broader definition.

Second, it is arguable that the proposed definition can be read to only apply to entities with legal personalities. One would need to ensure that it also captures divisions of larger firms, such as, for example, Standard & Poor's, Rating Services, a division of The McGraw Hill Companies. Otherwise there is a risk that the definition applies to the larger legal entity, whose main business is not the issuance of credit ratings.

Q2. Do you agree with the definition of credit ratings? If not, please state your reasons.

We agree with CESR's proposal to follow the IOSCO Code definition. As such, CESR's definition should read: "an opinion regarding the creditworthiness etc." It is also important to make it clear that credit ratings are not recommendations.

Q3. Do you agree with the definition of unsolicited ratings? If not, please state your reasons.

We support CESR's attempt at bringing more clarity to the market in this area. This is a critical issue for CRAs, issuers and investors alike.

We fear however that CESR's definition, namely that unsolicited ratings are credit ratings produced by a CRA on its own initiative, does not achieve the desired outcome and could, in some instances, be misleading to investors.

We do not think that initiative alone is an appropriate benchmark. One reason is that it may be difficult to prove; another is that it may not matter. Who first picks-up the phone is not necessarily relevant. The CRA may have done, but if the issuer then wishes to participate, the resulting rating should not appear as unsolicited. Conversely, if the issuer approaches a CRA and then decides to stop the process or use another CRA, it would be inappropriate for the CRA first approached to be allowed to publish a rating as solicited.

This issue arises because of the lack of market clarity regarding the nature and extent of issuer participation in both "solicited" and "unsolicited" ratings. The market generally views unsolicited ratings as solely based on publicly available information, and therefore "weaker" than solicited ratings. However, the market also knows, as CESR rightly points out, that unsolicited ratings do not equate automatically to ratings produced without co-operation from the issuer. Conversely, the market recognises that solicited ratings do not necessarily mean ratings produced with full issuer participation.

We would therefore suggest that CESR does not attempt to define unsolicited ratings. CESR should instead advise the Commission that CRAs to be more transparent in (1) publishing their policies on unsolicited ratings, and (2) defining the nature and contents of each unsolicited rating, having regards, in particular, to the degree of issuer participation based on factors such as (i) the willing provision of information (which may include confidential information) by the issuer to the CRA, (ii) regular issuer management involvement, and (iii) ongoing dialogue between the issuer and the CRA.

This is an area where the IOSCO Code provides great opportunities for increased competition in the way CRAs may implement its provision on unsolicited ratings.

Q4. Do you think that issuers should disclose rating triggers included in private financial contracts?

We believe that issuers should disclose material rating triggers and that this is becoming increasingly the practice as a result of the Prospectus Directive.

Q5. 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.

We do not think that this is needed. We agree with CESR that this would require a case by case approach and compelling cost/benefit analysis.

II. COMPETITIVE DIMENSION: REGISTRATION AND BARRIERS TO ENTRY

Q1. 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? Q2. 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 recognise that the business of providing credit ratings has historically been a difficult one for new entrants to penetrate because of the market's tendency to seek ratings from firms with a proven track record and global reach. Importantly, we do not believe that this has caused a market failure or that it is preventing debt capital markets from operating efficiently.

Barriers to entry in the CRA industry are natural rather than the result of any anti-competitive behaviour from the more established CRAs. We note that size and experience, resource levels, unwelcome practices from competitors, start-up and other costs, consolidation and specialisation are day-to-day challenges that all businesses face.

We do not believe that the difficulties that new entrants encounter in increasing market share are likely to be reduced as a result of regulatory intervention. On the contrary, we would submit that the introduction of new registration procedures or regulation for CRAs would most likely increase barriers to new entrants and would duplicate envisaged requirements under Basel II. On the other hand, the quality and reliability of ratings could be damaged if registration thresholds were lowered to ensure recognition of some small CRAs that have no track record or weak processes. Finally, further regulation of the ratings sector is likely to have a disproportionate compliance impact on smaller players as compared to larger, established CRAs.

We also believe that the argument that obtaining registered status would help a CRA gain market credibility is flawed. In a reputations-based industry, such as the ratings industry, the market is the real judge of credibility.

We think that it is important, in this debate, to bear in mind both the immature state and specific features of the European bond market in which CRAs operate, as highlighted in a recent European Central Bank Study[2].

The introduction of the Euro has shifted investors' focus from currency risk to credit risk. This has increased the role of CRAs; however the European market for ratings remains under-developed (compared to the US). Moody's recently estimated that there are 1,500 unrated European institutions with annual revenues of at least Euro 1 billion. Therefore, we believe there are significant opportunities for CRAs of all types and sizes to develop.

In addition, the European market still relies heavily on bank intermediation financing, which can be monitored without recourse to CRAs. Further, European corporations still place enormous importance on relationship banking, thereby reducing the need for independent credit assessment. Finally, companies in Europe is still very much rely on "domestic name recognition" for raising funds locally without being rated. We believe, therefore, that these characteristics of the European financial market explain to a large extent the relatively low level penetration of SMEs in the European ratings market.

However, growing disintermediation and the related development of the European bond market offer real opportunities for increased competition between CRAs and further market penetration by small CRAs in the context of greater overall ratings coverage. These opportunities are further enhanced by the flexibility that IOSCO offers in the way CRAs might implement the provisions of its Code. Additional regulation raises a significant risk of these opportunities being lost and of negatively impacting the growth of a still developing European bond market.

III. RULES OF CONDUCT DIMENSION

<u>Interests and conflicts of interest</u>

Q1. 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 CRA (i) introduce and disclose policies and procedures for management

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[2] The Euro Bond Market Study, December 2004, available at http://www.ecb.int/pub/pdf/other/eurobondmarketstudy2004en.pdf

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 that user and issuer confidence in credit ratings is vital for the smooth functioning of securities markets and that to enhance market confidence CRAs must issue independent, objective and high quality credit ratings and must be perceived to do so. We recognise that potential conflicts of interest may exist between CRAs, the issuers they rate and the users of ratings. However, as CESR points out, the mere existence of conflicts of interest does not automatically imply a market failure. As a result, it is appropriate to require that a CRA have policies and procedures to address potential conflicts of interest, including potential issuer and subscriber influence.

We believe that the IOSCO Code Provision 2.6, in requesting that CRAs adopt and disclose internal procedures and policies to deal with the identification, elimination, management and disclosure of any actual or potential conflicts of interest that may influence the CRA, will, if properly implemented, adequately address the risks of such conflicts of interest arising.

It is unnecessarily cumbersome to require CRAs to disclose that the policies and procedures have been observed for each rating; however, each rating opinion should contain an internet hyperlink, displayed prominently, to the policies and procedures in question so they can be accessed by users of rating.

Ancillary services

Q2. 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 CRA 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?

Q3. 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?

Q4. 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?

We first address Q2 and Q4.

It is essential to understand that two of the services categorised by CESR as ancillary services are in fact core ratings services that are central to the proper functioning and reliability of a CRA's ratings business. These two core services are (i) research services, and (ii) rating assessment (or evaluation) services ("RAS/RES").

(i) Research Services

It is critical that CRA research be understood as a core ratings service. Most of the research provided by CRAs is of an explanatory nature regarding a particular rated company, issue or sector. It is an indispensable by-product of the rating that provides issuers and investors with the background and rationale for a rating decision and is provided free of additional charge to existing subscribers.

As a result, there is no opportunity for conflicts of interest to arise in this situation and it is important for the quality of the rating that the rating analyst should also be involved in the research. We urge CESR not to approach the provision of research by CRAs in the way that MAD approaches the provision of research recommendations by investment firms. Once again, ratings are opinions, not recommendations. Related research that further supports ratings does not turn them into recommendations.

(ii) RAS/RES

CRAs provide RAS/RES services to issuers, which involve providing a specific opinion to an issuer on the rating impact of one or more theoretical scenarios backed by a formal committee-based process. We consider this service to be an integral part of a CRA's ratings business, and we do not believe that rating analysts should be prohibited from both participating in RAS/RES activities and performing work on a rating for the same issuer. Nor do we believe it appropriate to ban the provision of this type of service simply because of the potential conflicts that arise. The analysis involved in the two activities is the same and having a single analyst performing the work for both results in a higher quality of service to issuers and of ratings generally. Further, we do not believe that performing one activity affects the judgment of an analyst in performing the other. We believe, however, that analysts should be prohibited from soliciting RAS/RES work from issuers, since such involvement might exert subtle pressure on issuers to purchase RAS/RES services. Similarly, issuers being solicited for RAS/RES work should be informed that refusal of the service will in no way be disclosed to the rating team and will have no effect on a rating. These aspects should be reflected in CRAs' codes of conduct.

With regard to other services, which might more accurately be categorised as "ancillary" services, we would strongly oppose bans or other regulatory restrictions on the provision of such services by CRAs as the answer to conflict resolution. Firstly, because it would create additional barriers to entry for smaller CRAs and new entrants who may need to rely significantly on the revenues from such services. Secondly, because if properly managed, potential conflicts of interest arising from the provision of ancillary services by a CRA to an issuer should not prevent the CRA from delivering and being seen to deliver independent, objective and high quality credit ratings in which users have confidence. We believe that the IOSCO Code Section 2, in requiring CRAs to (i) separate their ratings and ancillary businesses, (ii) have conflict of interest policies in place even in respect of ancillary services that do not necessarily present a conflict, and (iii) disclose such policies as well as actual and potential conflicts in a "timely, complete, clear, concise, specific and prominent" manner, provides ample adequate safeguards.

It is unnecessarily cumbersome to have CRAs disclose that the policies and procedures have been observed for each rating; it is sufficient that each rating opinion contains an internet hyperlink to the policies and procedures in question that users can access.

Regarding **Q2**, CESR is correct in stating that CRAs providing input on structured finance ratings play a more active role than in corporate ratings and that the sponsor has (generally) greater flexibility to adapt the features of the transaction in order to achieve the desirable outcome; however, we do not believe that structured finance ratings raise additional conflicts of interest concerns. Rather, we believe that this reflects how these markets differ from corporate ratings because of their more complex aspects and the fact that the rating focuses not so much on the creditworthiness of the issuer but instead on the quality of the underlying assets and on the robustness (in terms of insolvency remoteness of the rated entity) of the transaction structure. As such, it is inevitable that CRAs play a more active role as they need to ensure that they fully understand and adequately rate the proposed structures. It is essential to the production of good ratings in this area that the banks' structuring desks and legal departments have a full and close dialogue with CRAs.

Because of the greater complexities, the main issues with structured finance ratings are the transparency of CRA methodologies and the consistent application of such within the same CRA[3]; we therefore welcome the latest addition to IOSCO Code Provision 1.3, now requiring that analysts apply a CRA's methodologies in a consistent manner.

Payments by issuers

Q5. 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 CRA (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 find CESR's reduction of the potential for conflicts to diverging interests between CRAs (profit making) and issuers (obtaining the best rating) somewhat simplistic. We would argue that CRAs' and issuers' interests strongly converge towards the production of independent and accurate ratings that are stable over time and that this by far outweighs the above. Further, the fact that CRAs have a strong reputational incentive to produce accurate and independent ratings for the investor community acts as an effective counterbalance to concerns about possible CRA and issuer collusion.

We believe that the IOSCO Code, in particular Provisions 2.3 (a credit rating should be influenced only by factors relevant to the credit assessment) and 2.8 (requiring disclosure of a CRA compensation arrangement with rated issuers), provide adequate

[3] For more details see BMA's response to CESR's call for evidence on Possible Measures Concerning Credit Rating Agencies, available on CESR's website at http://www.cesr-eu.org/.

checks and balances to ensure that any perceived risk of issuer influence is properly managed.

We do not think it appropriate to require CRAs to disclose that such scheme has been applied for each rating. Many transactions of the same type will have their own intricacies and specificities, requiring more or less analyst involvement; CRAs, issuers and their advisers need to be able to discuss the most appropriate fee in each case, within the parameters set by the scheme.

Unsolicited credit ratings

Q6. In order to deal with issues related to unsolicited ratings, to what extent do you agree that it is sufficient to have the CRA (i) introduce and disclose policies and measures with regard to issuing unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?

Please see our response to Q3 on page 2. We believe that our approach would go a long way towards addressing the issues related to unsolicited ratings and that it should be adopted by CRAs in their implementation of the IOSCO Code. In particular, a CRA should explicitly prohibit its analysts from attending marketing meetings with an issuer that may follow from the issue by such CRA of an unsolicited rating on such issuer where the purpose of the meeting is to discuss possible conversion of the unsolicited rating to a solicited rating, as this may involve discussion of CRA fees.

Capital or other interest links

Q7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a CRA and an issuer might influence the credit ratings process it is sufficient to have the CRA (i) introduce policies and measures managing and disclosing financial links or other interests between a CRA 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?

We believe that the IOSCO Code addresses the key situations where the market would expect conflicts to be disclosed and we note that some CRAs, in their own codes, are already going beyond IOSCO's requirements in certain respects. This is another area where the IOSCO Code, having laid strong foundations, can allow competition between CRAs to develop and let the CRAs themselves, conscious of their reputation, set the highest standards for the benefit of the entire market place.

It is unnecessarily cumbersome to require the CRA to disclose that the policies and procedures have been observed for each rating; however, each rating opinion should contain an internet hyperlink, displayed prominently, to such policies and procedures in question that users can access.

<u>Fair Presentation</u>

Levels of skills of CRA's staff

Q1. 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 CRA (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 agree with CESR that CRAs should devote and be seen to devote the necessary resources to provide for adequately skilled staff and ensure that all staff involved is and remains qualified to do so in terms of training, expertise and experience. Provisions 1.4 and 1.7 of the IOSCO Code require CRAs to have and disclose policies to that effect. We believe these provisions to be sufficient to address the risk highlighted by CESR. Any further requirement may interfere with CRAs' internal Human Resources management.

We do not believe it is useful for CRAs to disclose the skills of their staff for each rating. We are concerned that this would allow the rated company to challenge a rating based on the qualifications of a single analyst. It is important to remember (which is a requirement of IOSCO Code Provision 1.4) that the ratings process at a CRA is a collaborative one. Thus, a final rating is not the product of a single analyst, but of a committee.

As with any company, a CRA franchise and reputation is a function of the quality of its personnel. CRAs therefore have strong commercial incentives to ensure that specific qualifications are met as they relate to staff skills.

Q2. 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?

CRAs should undertake and publish studies on rating default and trends in a more systematic and more user-friendly manner.

Methodologies used for building credit ratings

Q3. Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?

In theory, yes. However, see our response to Q5 below.

Q4. 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?

A CRA should have written methodologies that are rigorous, systematic, adequately disclosed and consistently applied. However, a CRA should also be able to elaborate appropriately on the application of and or deviations from such methodologies as it relates to individual ratings.

We see no benefit whatsoever for the issuer or investor community in regulators regulating CRA methodologies.

First, methodologies alone do not drive credit ratings, they are applied to each particular transaction. They are then subjected to the collective analysis by the CRAs. This is where judgment comes into play and why credit ratings are opinions. Second, there are a variety of subjective factors about the management of an issuer that are crucial to the rating process. Such factors are not conducive to quantification by a regulator. Third, users of ratings benefit from seeing differing analyses of the same issuer, which might be less likely to occur if the regulators have mandated a particular methodology. Fourth, in the fixed income area, there is a substantial amount of innovation in terms of new products and variations on existing products. If a CRA could not rate a new product until a regulator approved a rating methodology for the product, it might add a substantial amount of time to the rating process, and windows of opportunity created by a particular interest rate environment might be lost. Finally, as CESR points out, regulation could give the market the wrong impression that regulators are able in some ways to guarantee a certain level of quality of rating, which could in effect make regulators accountable for rating outcomes.

We believe that common global standards have already been set by the international regulatory community through the IOSCO Code and that this provides the best way to ensure that global standards are achieved in a flexible and competitive manner.

Q5. 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 support the ten IOSCO Code Provisions that deal with or refer to CRA methodologies and believe them to be sufficient, in particular Provisions 1.2 (CRA rating methodologies should be rigorous and systematic and ratings should be subjected to validation based on historical experience), 1.3 (analysts should use methodologies established by a CRA in a consistent manner), 1.4 (ratings should reflect all public and non-public information known and believed to be relevant to the CRA), 3.5 (a CRA should publish sufficient information about its procedure, methodologies and assumptions so that outside parties can understand how a rating was arrived at), and 3.10 (CRAs should fully and publicly disclose material modifications to their methodologies prior to them going into effect).

Regarding the latter, we believe that both issuers and investors would benefit from advance notice of changes to methodologies and of the timetable for implementation of such changes. This is an area, however, in which flexibility is required.

Pre-disclosure is critical to issuers and their advisors who need to know in advance the methodologies that will be applied to the issuer's creditworthiness and/or debt securities. This is especially important because securities may need to be sold quickly to take advantage of short market windows, or because a change in methodology may alter ratings or delay transactions, thus impacting on the issuer's ability to fund itself.

However, it is also essential for the protection of investors and the integrity of the rating process that CRAs may freely alter their views of the criteria to obtain a particular rating and the best methodology for assessing creditworthiness. Only then can they adapt to fast changing circumstances and product developments. CRAs should not therefore as a rule be prevented from effecting changes to their rating methodologies simply because they have not yet disclosed such changes to issuers and investors (provided that such changes are then applied consistently).

We believe IOSCO Code Provision 3.10 now achieves the desired compromise.

Q6. 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 per our response to Q4 above, we see no benefit in regulating all or, for this matter, part only, of CRAs' methodologies. It should be left to the CRAs to compete for the most appropriate, most attractive and most reliable methodologies, with the market as arbiter.

<u>Relationship between issuers and rating agencies</u>

Access to inside information by CRAs

Q1. 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. We thank CESR for its helpful analysis. This no doubt contributed to the deletion of the old IOSCO Code Provision 3.11 which market participants had requested.

Q2. 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? Q3. 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?

Again, we thank CESR for its helpful analysis and, although outside its mandate, we consider that it is appropriate for CESR to focus not just on access to inside information held by an issuer, but also on inside information generated by a CRA given that a rating action may indeed amount to inside information.

This issue arises because CRAs usually give issuers an opportunity to correct any factual inaccuracies that have been relied on in determining the rating before the issuer agrees to make it publicly available. Although we believe that it is essential that issuers, their advisors and CRAs may preserve such practice, it is equally important to ensure that the risks of inadvertent dissemination, selective disclosure or other misuse of inside information are subject to adequate controls.

We believe that such controls exist within issuers and their advisors. Rating advisors typically work for regulated investment firms supervised by multiple regulators. Further, the way the current practice is structured severely limits the risks just highlighted. CRAs only give issuers a few hours to check imminent releases for factual incorrectness and /or removal of confidential information. This, together with the threat of market abuse under MAD, provides, in our opinion, for sufficient safeguards for the market. This would also explain why, to our knowledge, there have only been exceptional cases of inadvertent dissemination by issuers. These exceptional cases do not outweigh the overwhelming positives of ensuring that the market gets accurate information and, as CESR points out, there would be no or little incentive for a CRA to give an issuer advanced notice of a rating if the issuer was then going to itself publish it.

It is therefore our view that issuers should not be required to disclose imminent rating changes and that MAD sufficiently addresses the risks highlighted above. CRAs should make it clear in their codes that the sharing of rating reports with issuers or their advisors prior to publication is limited both in scope (to correct factual inaccuracies and remove any non-public information) and in time, although, in some instances, issuers and their advisors may identify reasonable grounds on which to challenge a ratings outcome (see Q8 below).

We do not believe that preventing the communication of any information to subscribers of CRA services that is not also made public will provide any additional meaningful safeguard. Our understanding is that CRAs do not provide information of a confidential or price sensitive nature selectively to subscribers.

Q4. 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. The combination of MAD, the Prospectus and Transparency of Obligations Directives and the International Financial Reporting Standards will generate additional available information to the marketplace as a whole. In addition, see our comments under Q11 below.

Q5. 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.

Q6. Do you consider that it would be helpful to have a dedicated regime governing CRAs and their access to inside information?

No. We believe that existing EU legislation (and for that matter, US legislation as well) and the IOSCO Code Section 3(B) dedicated to the protection of confidential information provide sufficient tools to deal with issues relating to CRAs' access to inside information.

Other issues concerning the relationship between issuers and CRAs

Q7. 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?

This question goes to the transparency of the rating process. We consider that IOSCO Code Provisions 3.5 (a CRA should publish sufficient information about its procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at), 3.6 (CRAs should explain in their press releases/ reports the key elements underlying their rating decision), 3.7 (Prior to issuing/revising a rating, CRAs should advise issuers of the critical information and principal considerations upon which a rating will be based and afford issuers the opportunity to clarify factual misperceptions), and 3.8 (CRAs should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if/how ratings categories have changed) provide significant practical steps to enhance rating users' understanding and benchmarking ability.

We believe that these written measures, now also supplemented by IOSCO Code Provisions 4.2, are indeed sufficient. The rest is down to further education efforts by CRAs. We believe that CRAs should organise periodic meetings with special interest groups (e.g., an issuer group, an investment banker group and an investor group) to discuss the needs and issues of these groups.

Q8. 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 CRA's opinion?

As mentioned above, in some instances issuers and their advisors may identify reasonable grounds on which to challenge a ratings outcome, at which time a formal appeal process may be launched at the request of the issuer. This would typically happen where new material information regarding the issuer becomes available. CRAs generally have internal guidelines related to such appeals, S&P's code of conduct contains specific provisions relating to appeals. We would welcome all CRAs to explicitly provide for and describe in their codes the appeal process that is afforded to issuers and their advisors to appeal rating decisions, it being understood that such process should carefully balance issuers' rights and CRAs independence.

Q9. 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?

In our view, the combination of (i) the importance for CRAs' to build or protect a credible franchise, (ii) IOSCO Code Provisions 1.1 to 1.8 (relating to the quality of the rating process), in particular Provision 1.6 (The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation), (iii) the offence under MAD (relating to dissemination of false or misleading information), and (iv) the fact that issuers are under similar obligations under MAD, provide ample safeguards to ensure that the information published by CRAs is as accurate as it can be.

Q10. 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?

We believe that this may be best left for the CRAs to specify in their own codes of conduct in pursuance to IOSCO Code Provision 1.5 requirements.

Q11. 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?

We believe that it is entirely inappropriate for regulation to introduce measures to ensure a level playing field in terms of access to information for CRAs, irrespective of whether ratings are solicited or not. There should be no obligation on an issuer to provide information to CRAs that have not been appointed by such issuer. In addition, although, as a general principle, an issuer should give equal information access to all of its appointed CRAs, if an issuer decides it is not in its best interest to provide non-public information to a particular CRA, measures should be limited to requiring disclosure that the CRA's rating reports are based solely on publicly available information. Measures should further ensure that the information provided is not false or misleading. Both such measures already exist by virtue of MAD and the IOSCO Code. No additional measures should be introduced that would have the effect of forcing issuers to speak with all (or all of their appointed) CRAs. As CESR points out it could also have the pernicious opposite effect of forcing the issuer to only speak to one. Regulation should not intrude unnecessarily into economic, strategic or relationship decisions made by issuers.

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

Q1. 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?
Q2. Could you please indicate your preferred option and highlight pros and cons that you see with regard to each policy option?

For the reasons set-out below, we believe that Option 6 is the only viable option.

A OUR STRONG PREFERENCE

Option 6: Monitoring the market developments

We strongly believe that enforcement of the IOSCO Code by the market offers the strongest, most cost-efficient and most immediate answer to current regulatory concerns.

The market does and will react to a CRA losing or gaining credibility in the eyes of the investor community (as evidenced by Fitch's increasing market penetration). We disagree with CESR that this amounts to "do nothing" because it fails to recognise the work that has already been done by the regulators with Basel II and the publication of the IOSCO Code. The latter represents a significant development in terms of investor protection.

We also disagree with CESR that there would be an uncontrollable shift of power to the CRAs, away from investors and issuers. We believe that CRAs have done a very good job of predicting credit quality over time and they have made much progress improving their methodologies, rigor and transparency since the recent economic downturn as a result of market forces (i.e. investor demands). CRAs are responding to public scrutiny and media focus. In recent years, they have been responsive to the market through more active disclosure of changes in methodologies and publication or preparation of codes of conduct. CRAs should therefore be given the opportunity to respond more fully, in a positive and proactive manner, to the IOSCO Code. They have a strong economic and reputational incentive not only to strive to comply, but to be seen to be embracing the new framework constructed by IOSCO.

For this reason, we also disagree that the IOSCO Code could become toothless. Users and investors are engaged. They will observe how CRAs implement the IOSCO Code and will react to the way CRAs "comply or explain". We have recommended to CRAs some practical steps for putting the IOSCO framework on a concrete footing, e.g. regular reporting on various IOSCO requirements and setting-up forums for specific user groups and have made further practical suggestions in this letter. There is no substitute for market acceptance of the value and credibility of ratings from a certain CRA. This is not something that can be bestowed upon a CRA by regulation, registration, or arbitration. Market sanctions can be as effective as regulatory sanctions in a reputations-based industry.

We believe, therefore, that the only sensible and pragmatic next step is to allow CRAs the opportunity to implement the IOSCO Code, demonstrate compliance with it and adopt the recommendations suggested in this letter, rather than to rush into regulation or arbitration responses which will very likely adversely impact the quality and availability of ratings, without improving competition. There is no need in our view to create additional regulatory burdens in the area of credit ratings. It would be inconsistent with the current aim of the EU, which is to reduce the intervention of regulatory policy. It would also be inconsistent with the overwhelming market feedback received by CESR and IOSCO on this matter.

Any option other than Option 6 therefore only risks: (i) reducing competitive opportunities that the European market and the IOSCO Code offer; (ii) confusing the market with duplication or multiplication of EU regulatory systems; (iii) losing the international consistency and consensus offered by a self-regulatory approach towards implementation of the IOSCO Code; (iv) reducing the quality and availability of ratings because of the likely impact of regulation (or, for this matter, arbitration) on the analytical process; and (v) causing significant costs to the industry that would likely be borne by investors and issuers, all this for very unclear gains to users of ratings.

B) ALTERNATIVE OPTIONS?

Option 1: Registration/Regulation Regime (intrusive)

It is reassuring that CESR finds it difficult to list many pros in support of this option. Even the arguments in favour made by CESR seem weak. For example, advancing that this registration model could be useful for new or smaller agencies, because they would receive from it recognition of their expertise, very much depends on the registration criteria that are adopted. Under option 1, these are likely to be numerous and demanding, thereby preventing entry.

Regarding the cons, we agree with CESR that creating another regulatory system for CRAs in the EU, in addition to Basel II, could lead to duplication of the regulatory burden for CRAs and effectively increase barriers to entry, further preventing competition among CRAs. As to CESR's argument that intrusive regulation may give investors the impression of a sort of guarantee given by regulators of quality of ratings, we believe that investors should be entitled to expect near perfect reliability and quality of ratings to the extent that all aspects of a CRA's business are to be regulated in detail. This highlights the importance of determining the regulatory purpose of this option. Because of its negative impact on the analytical quality of CRA opinions (regulating an analytical process involving subjective opinions can only cause a detrimental impact on the quality and diversity of ratings information), the only sensible purpose of this option is that the CRAs' analytical processes lead to inaccurate or biased ratings. This in turn requires evidence of a systematic failure. As far as default studies go, these demonstrate a consistent and clear correlation between long-term corporate debt ratings and the probability of default. As far as Enron and Parmalat are concerned, these events involved fraud that CRAs cannot be expected to detect. Market participants accept that they cannot expect any CRA, or ratings systems, to act as a perfect evaluator of credit risk or quality because of the complexity of evaluating the various objective and subjective factors that affect creditworthiness and reflecting them in a single symbolic rating; CRAs should not and cannot be reasonably charged with uncovering and evaluating all possible undisclosed risks or liabilities that might affect credit quality, or with uncovering fraud or other misconduct by issuers. CRAs, like other market participants, must be able to rely on the integrity of the audit process to produce financial information that is accurate and complete. Although they may have access to certain information not contained in public disclosures of issuers, they lack the resources and expertise to conduct an independent audit of all the financial information produced by the issuers they rate and cannot be expected to police in any meaningful way the review conducted and decisions made by accounting professionals.

Also, intrusive regulation will inevitably have a detrimental impact on CRAs' ability to be responsive to market developments. This is particularly relevant to methodologies where regulation may prevent CRAs from quickly adjusting to market developments or innovation, which would, in turn, reduce the quality and availability of information.

Finally, it is important to remember that there are many other compelling counter-balancing market-driven "checks" in place, for example: CRAs' own reputation (including default studies), investment firms' and banks' own research departments, other research providers, investors' and issuers' own risk management functions, and other available market information. Looking at research for a moment, it is important that certain lessons are learned from the detailed regulatory disclosure requirements in MAD which, as can already be seen, are causing less and less research to be published, in particular in the bond markets.

Option 2: Registration/Regulation Regime (light)

We acknowledge that there are more "pros" and less "cons" under this option than under Option 1. In concept, we believe that having 1 registration system for the whole EU market would require that process to be managed in a consistent manner across the EU (and also between the EU and the US);

Still, we would have the same concerns as those raised under Option 1 above. In addition, as CESR points out, it would require the modification of CESR's legal profile through EU legislation. The practicalities, time and politics involved in the process being likely to be significant, we do not see this as an immediate option.

The implementation details of Option 2 would need much greater clarification and a thorough cost/benefit analysis should be carried out before we can begin to consider it.

Option 3: Including the IOSCO Code within Basel II recognition procedure

Although we can see the attraction in this approach in terms of trying to promote a consistent European regulatory system for the use of credit ratings, we do not believe that this overly complicated multi-layered option is appropriate. Leaving aside the difficulty we have in working out how it would be practically implemented, we believe that it risks bringing two different regulatory purposes into one to the detriment of competition.

Again, we question what underlies the regulatory purpose of this option. It seems to us that, in the context of Basel II, regulation of ECAIs aims at ensuring safe risk management by banks of their capital reserves through, among other things, holdings of instruments that are rated following, understandably, a strict and demanding process designed to achieve that purpose and therefore focused more on aspects of CRA market experience, credibility, independence, international access and resources, less so on competition, conduct and issuer/CRA relationships; as such a large number of the criteria for eligibility of ECAIs will not be suited to smaller CRAs and new entrants and codes of conduct are of lesser relevance.

In addition, as CESR points out, following the Basel II infrastructure would leave it open to member states to implement IOSCO Code in different ways and the international consensus that the Code has achieved could be lost.

Further, as CESR also points out, Basel II will only cover those CRAs that want to be recognised for external ratings and it being not obvious that all CRAs will have an interest in becoming recognized in this respect, Basell II criteria are not necessarily much stronger than market-based enforcement.

Option 4: Third party's certification or enforcement of the IOSCO Code

We believe that a CRA, not a third party, is in the best position to certify compliance or indicate and explain areas of non-compliance with the IOSCO Code; CRAs should carry out this exercise and the market can assess the consequences. This approach is now embedded into the "comply or explain" IOSCO Code Provision 4.1 and supplemented by Provision 4.2 which requires CRAs to set-up internal compliance functions that may received concerns and complaints. CRAs will be motivated to regularly carefully review their operations by interest in preserving their franchise.

Further, we do not think that CESR has given the cons of arbitration a fair assessment. The issue is not so much the difficulty in identifying a really independent third party, but rather, like option 1, that this option may lead to annihilate the subjective component of rating opinions[4].

Option 5: Relying on rules covering only specific aspects of CRAs' activity

Although this option seems more attractive because of its stronger self-regulatory focus than any option other than Option 6, we are not clear, from CESR's explanation, how the self-regulatory aspects would interact with the Basel II requirements. We are also uncertain as to whether the "two ways" described by CESR are cumulative or exclusive.

As for Option 2, the details of the implementation of Option 5 would require much greater clarification and a thorough cost/benefit analysis should be carried out before we can consider it more fully.

Q3. Do you think the IOSCO Code is conducive to reducing or increasing competition?

We believe that the IOSCO Code is conducive to increasing competition, so long as it remains enshrined in a self-regulatory environment and is not transformed into a set of regulatory requirements. Throughout this letter, we have highlighted several areas where the IOSCO Code provides all types of CRAs with the opportunity to gain competitive advantages in the way the implement the IOSCO Code, for the further benefit of users of ratings.

[4] For further details see BMA's response to the Report of the Chairman's Task Force of the Technical Committee of the IOSCO regarding a *Code of Conduct Fundamentals for Credit Rating Agencies* available on IOSCO's website at http://www.iosco.org/pudocs/pdf/IOSCOPD177.pdf.

Q4. Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?

No.

CONCLUSION

The only plausible rationale for the adoption of any option other than Option 6 must be that the regulators have no confidence in the CRAs implementing the IOSCO Code or in the market policing implementation.

We do not believe that CESR necessarily lacks that confidence and recognise that CESR may be under some pressure to propose regulatory-based options. While we acknowledge that these pressures exist, we stress that any proposed regulatory oversight should achieve all of the following objectives:

- It should give primary reliance to self-regulation within the parameters of the IOSCO Code
- It should avoid a fragmented "market-by-market" approach which would be onerous and costly for the market as a whole.
- It should be designed and applied in a coordinated fashion, both across the EU and with the US.
- It should be principles-based.

We would like to thank CESR for their thorough review of the CRA topic. We remain at your disposal for any further assistance that CESR may wish to draw from our Working Group.

Yours faithfully,

Bertrand Huet-Delaherse
European Legal & Regulatory Counsel
The Bond Market Association

On behalf of:

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ANNEX

Response to CESR's technical advice to the European Commission on possible measures concerning credit rating agencies - Consultation Paper November 2004

DETAILED SUMMARY
21 February, 2005

A summary of the Bond Market Association Credit Rating Agencies Working Group's key views and comments on CESR's consultation document is provided below.

BARRIERS TO ENTRY

1. There is no evidence in the form of a market failure that would serve as a rationale for further regulatory intervention. Barriers to entry in the CRA industry are natural rather than the result of anti-competitive behaviour from the larger CRAs.

2. The introduction of new registration procedures or regulation for CRAs would most likely increase barriers to new entrants and would duplicate envisaged requirements under Basel II and the proposed Capital Requirements Directive. On the other hand, the quality and reliability of ratings could be damaged if registration thresholds were lowered to ensure recognition of some small CRAs that have no track record or weak processes. Further, it is unlikely to HELP make a CRA credible, since the market is the real judge of credibility.

3. The characteristics of the European financial market, with continued high reliance on bank intermediation financing and on domestic name recognition for raising funds locally explains to a great extent the relatively low level of ratings penetration of SMEs.

4. Disintermediation and the related development of the European bond market offers real opportunities for increased competition between CRAs and further market penetration by small CRAs in the context of greater overall ratings coverage. These opportunities are further enhanced by the flexibility that IOSCO offers in the way CRAs might implement the provisions of its Code. Further regulation raises a significant risk of these opportunities being lost and of negatively impacting the growth of a still developing European bond market.

RULES OF CONDUCT

1. Conflicts of interest

A) General

1. All aspects are satisfactorily dealt with by the IOSCO Code, which also provides opportunities for further competition in the way CRAs implement the Code.

2. In particular, the IOSCO Code requires CRAs to introduce and disclose policies for addressing potential conflicts of interest. The precise manner in which CRAs choose to do this should not be restricted since market participants can judge whether such policies appear comprehensive.

3. Any proposed regulation should be limited to requiring CRAs to introduce and disclose policies for management and disclosure of conflicts. It should not regulate the contents of such policies.

B) Ancillary services

1. It is essential to understand that research and rating assessment/evaluation ("RAS/RES") services are core rating services, not ancillary rating services.

2. The IOSCO Code, in requiring CRAs (i) to have and disclose policies, and (ii) to effect the practical separation of rating and ancillary services, provides a sound framework on which CRAs can build. For example, ratings analysts should not be prevented from undertaking RAS/RES activities; however, CRAs' codes of conduct should stipulate that they do not engage in the solicitation of such services.

3. Prohibiting CRAs from providing ancillary services altogether would most likely raise barriers for new entrants and smaller CRAs.

C) Unsolicited Ratings

1. Attempting to define unsolicited ratings is difficult and may be misleading, as the information on which they are based and the degree of issuer involvement can vary from one unsolicited rating to the next. In focusing on which party initiated the contact between CRA and rated entity, we think CESR is unlikely to clarify the current confusion over the status and content of unsolicited ratings and risks, instead, increasing this problem.

2. The focus should be on requiring CRAs to be more transparent in defining (i) what their policies are on unsolicited ratings, and (ii) the nature and contents of each unsolicited rating, in particular the degree of issuer participation. This is another area where IOSCO Code provides an opportunity for further CRA competition.

3. Prohibiting unsolicited ratings altogether would most likely raise barriers for new entrants and smaller CRAs.

<u>2. Fair presentation</u>

A) CRA staff skills

1. It is important to remember that final ratings are the product of a committee, not a single analyst.

2. The IOSCO code requires that CRAs have and disclose policies to ensure that their staff is properly qualified. Any further requirement would risk interfering with CRAs'

internal Human Resources management or providing users who are unhappy with a particular rating opinion with an opportunity to challenge such opinion based on a CRA analyst qualification alone. This would hardly be constructive.

3. As with any company, a CRA franchise and reputation is a function of the quality of its personnel. CRAs therefore have strong commercial incentives to ensure that specific qualifications are met as they relate to staff skills.

B) Methodologies

1. Transparency of methodologies and consistent application of such by a CRA are essential. So, however, is the need for CRAs to be able to develop and adjust them in a flexible manner. Methodologies alone do not drive ratings - subjective judgment applied to methodologies does.

2. The 10 provisions of the IOSCO Code that deal with or refer to CRA methodologies provide adequate global standards regarding rules, disclosure and consistent application of CRA methodologies. The IOSCO Code also provides opportunities for further competition in the way CRAs implement such provisions.

3. Any proposed regulation should be limited to requiring a CRA to (i) disclose and update methodologies and (ii) ensure they are applied consistently. It should not dictate the methodologies that CRAs require, since this would limit innovation or improvements in approach.

<u>3. Relationship between issuers and CRAs</u>

A) Handling of inside information

1. The Market Abuse Directive (MAD) already provides a sufficiently robust EU framework to prevent and sanction misuse of inside information. The IOSCO Code also addresses the handling of non-public information. As such, there is no need for a separate dedicated EU regime governing CRAs.

2. The practice of CRAs giving issuers or their advisors an opportunity to review for factual inaccuracies prior to publication is not inconsistent with MAD. It is of benefit to the market as a whole and should be preserved. However issuers should not be required to systematically disclose inside information generated by the CRA itself.

3. Any regulation should be limited to requiring CRAs to introduce and disclose policies for the protection and handling of inside information. It should not regulate the contents of such policies.

B) Other

1. The various IOSCO Code provisions that require CRAs to better and more transparently communicate with issuers are positive developments. CRAs are encouraged to turn good intentions into practical reality. Transparent communication will be par-

ticularly important, both to the CRAs (competitive advantage) and the market, when CRAs describe their compliance or explain non-compliance with the IOSCO Code.

2. However, regulators should not regulate the manner in which CRAs communicate this information. Nor should they require issuers to communicate with all CRAs (agency data room).

REGULATORY OPTIONS

A) Our strong preference: Option 6 (Monitoring market developments)

1.Option 6 is by far the most sensible way of proceeding at this time

- There has not been a market failure or anti-competitive behaviour on the part of CRAs. There is therefore no valid regulatory rationale for introducing further regulation of CRAs.
- It is entirely consistent with the overwhelming market (including investors) feedback received by CESR and IOSCO
- It is entirely consistent with the European Commission's aim of avoiding unnecessary regulatory intervention

2.Any option other than Option 6 therefore only risks:

- Reducing competitive opportunities that the European market and the IOSCO Code offer
- Confusing the market with duplication/ multiplication of EU regulatory systems
- Losing the international consistency and consensus offered by a self-regulatory approach towards implementation of the IOSCO Code
- Reducing the quality and availability of ratings because of the likely impact of regulation (or, for this matter, arbitration) on the analytical process
- Causing significant costs to the industry that would likely be borne by investors and issuers, all this for very unclear gains to users of ratings.

3. Option 6 is not a "do nothing" option

- Regulators have already done a lot (and more is to come) with Basel II and the IOSCO Code. The latter constitutes a major development in favour of investor protection and transparency of CRA rating processes.
- CRAs are responding to public scrutiny and media focus. In recent years, they have been responsive to the market through more active disclosure of changes in methodologies and publication of their respective Codes. CRAs should be given the opportunity to respond fully, in a positive and proactive manner, to the IOSCO Code. They have a strong economic and reputational incentive not only to strive to comply, but to be seen to be embracing the new framework constructed by IOSCO.
- Users and investors are engaged. They will observe how CRAs implement the IOSCO Code and will react to the way CRAs "comply or explain". We have recommended to CRAs some practical steps for putting the IOSCO framework

on a concrete footing, e.g. regular reporting on various IOSCO requirements and setting-up forums for specific user groups. There is no substitute for market acceptance of the value and credibility of ratings from a certain CRA. This is not something that can be bestowed upon a CRA by regulation, registration, or arbitration. Market sanctions can be as effective as regulatory sanctions in a reputations-based industry.

- Option 6 is therefore effective, cost-efficient and consistent with investor protection. It also recognises the reputational nature of the credit rating business and does not raise barriers to entry.

B) Alternative options?

2. The only plausible rationale for the adoption of any option other than Option 6 must be that the regulators have no confidence in the CRAs implementing the IOSCO Code or in the market policing implementation. For the reasons explained above, we do not think that any other option is currently viable.

3. We recognise, however, that CESR may be under some pressure to propose regulatory-based options. While we recognise that these pressures exist, we stress that:

   - Primary reliance should be given to self-regulation within the parameters of the IOSCO Code
   - Any oversight/review by regulators should avoid a fragmented "market-by-market" approach which would be onerous and costly for the market as a whole. It should be designed and applied in a coordinated fashion, both across the EU and with the US.
   - Any regulatory oversight should be principles-based. We have provided some examples above (e.g. #1.A. 2: "Any proposed regulation should be limited to requiring CRAs to introduce and disclose policies for management and disclosure of conflicts. It should not regulate the contents of such policies).