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Fabrice Demarigny
Secretary General
Committee of European Securities Regulators
11-13 Avenue de Friedland
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15 August, 2006

Dear Mr Demarigny

Response to CESR's Questionnaire on the day-to-day application of the IOSCO Code by the credit rating agencies (CRAs)

The Bond Market Association's European office and its Credit Rating Agencies' Working Group¹ are pleased to have been able to assist in the CRA European debate to date, both via written submissions² and as organisers of the first ever Rating Industry Day in Paris earlier this year.

We are keen to continue to contribute to this debate and therefore thank CESR for the opportunity to provide feedback on the above-referenced questionnaire. Given the short period available for comments however, which also cuts across the summer holiday season, we have not been able to consider each of the questions in as much detail as we would have liked; we have therefore focused on the key areas where, in our experience, we have noted significant improvements as well as those areas where there is scope for further improvement.

Introduction

We support CESR's pragmatic approach to CRA ongoing review, via both its voluntary arrangements with CRAs and this questionnaire directed at market participants to assess progress to date as it relates to CRA self-regulation. We continue to believe that a "watch" brief for EU regulators that encourages market driven responses to regulators' concerns continues to be the right way forward.

Indeed, since the IOSCO Code was published in December 2004, all the CRAs that are NRSROs have upgraded and made public their own codes of conduct, and implementation reports, driven by the IOSCO Code "comply or explain" principle,

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.

² Eg, see BMA responses to IOSCO's proposed Code of Conduct Fundamentals for CRAs ([http://www.bondmarkets.com/assets/files/Response%20to%20IOSCO%20Final%20-%20Clean\(1\).doc](http://www.bondmarkets.com/assets/files/Response%20to%20IOSCO%20Final%20-%20Clean(1).doc)) and to CESR's consultation on Possible Measures Concerning CRAs (<http://www.bondmarkets.com/assets/files/cesr%20cp%2030%20nov%2004%20-%20final.pdf>)



are now also available on their websites, allowing interested parties to assess the significance of any deviations from the IOSCO Code.

This approach has raised the CRAs' awareness of the importance to not only have a publicly available code of conduct in place, but also to comply with it in practice, and is contributing to our overall sentiment that the transparency, integrity and objectivity of their credit ratings are more evident to market participants today than perhaps they were a couple of years ago. This sentiment seems to be shared by the issuer and investor respondents to BMA's February 2006 survey³, and this despite the fact that almost two-thirds of such respondents were not aware of the IOSCO Code at the time.

Improvements Noted

We now turn to two important areas of CESR's questionnaire where we have noted the greatest improvements.

The first most notable improvement relates to **item 1** of the questionnaire (**methodologies**), and in particular the disclosure aspect. We have noted and welcome the fact that CRAs are much more consultative of the marketplace in relation to proposed introductions of new methodologies and refinements to existing ones, thus providing enhanced transparency and predictability on credit ratings and rating actions (e.g. Moody's Global Sector Methodologies reports "mapping tools", market participants rejecting Fitch's proposed Joint Probability Analysis model methodology); in so doing, CRAs have generally made it clear which are the critical rating elements underpinning rating decisions, thereby also leading to improvements in respect of **item 5** of the questionnaire (**critical elements underlying the rating decision**).

We have further observed an overall improvement in the more consistent application by CRA analysts of the CRA methodologies, although this can vary depending on the level of details and complexity of the methodologies and may also, in part, be due to a resource issue (see below).

Beyond the area of methodologies, we have noted and welcome an increase in the frequency of CRA public communications generally, for example in terms of market analysis and educational opportunities, which supports their commitment to be more open and transparent, although the quality and frequency of research updates varies between agencies.

The second most notable improvement goes to **items 11 and 12** of the Questionnaire (**conflicts of interest**). In our experience, all major agencies now go to great lengths to ensure that adequate separations and firewalls exist between credit analysts and commercial staff, that only the latter discuss fees, and only when the analysts have left

³ BMA Rate the Raters Investors' and Issuers' Polls, 23 February 2006, available at: <http://www.bondmarkets.com/conferences/PollsCombinedFinal.pdf> (prepared in collaboration with the Association of Corporate Treasurers)



the room. The separation generally goes all the way to the most senior management level, as opposed to Group Managing Director level, as used to be the case.

However, in item 11.1 CESR still appears to improperly classify as ancillary services certain rating functions, in particular Rating Assessment/Evaluation services and research, which are in fact a core part of the analytical process and are central to the proper functioning and reliability of a CRA's ratings business. For the reasons mentioned on pages 5-7 of our response to the CESR Consultation Paper referenced in footnote 2 and again in our letter to the European Commission following CESR's advice⁴, we believe that it is wholly inappropriate for rating agencies to be required to separate these functions from their credit rating analysts.

Room for further improvement

We now highlight the main areas in CESR's questionnaire which, in our experience, still allow scope for further improvement.

The first and most notable relates to **item 8 (unsolicited ratings)**. We are still not observing systematic and clear disclosure and annotation of ratings which are unsolicited and as such based on public information only (without issuer participation), and this from one agency in particular. This information is valuable given the significant proportion of issuers that are subjected to unsolicited ratings and the fact that the majority of investors rely on such ratings⁵. We are not opposed to this practice *per se*; however, the information ought to appear in a more prominent fashion on all material produced by a CRA in relation to a particular issuer, and be available on a continuous basis (not just at initial press release/first-time rating stage).

Secondly, we believe that certain agencies could further improve in respect of **item 6 (ongoing ratings surveillance)**, through publication of more timely and more comprehensive rating updates, as well as periodic (at least annual) updates on all the names that the agencies rate. Further, the level of ongoing surveillance should be consistent across all types of issuers that a CRA rates (governments, investment grade and high yield corporates, insurers etc) and should not be influenced by an assessment by the CRA of the potential franchise risk involved in carrying out or not such surveillance.

Thirdly, regarding **item 1 (methodologies)**, there continues to be examples (eg in the area of operating leases and pension liabilities) of inconsistent application of methodologies within certain agencies, in particular where methodologies are accompanied by lengthy and complex CRA documentation on required adjustments (eg to financial ratio calculations). These would also be, typically, the areas where an analyst explanation of the critical elements underlying a rating decision may not always be clear (**item 5**).

This lack of consistency may also be due to, or exacerbated by, a lack of resources (**item 3.1**); we have noted a higher than usual level of staff turnover within the agencies in the last 18 months. Increased regulatory scrutiny, in particular in the area

⁴ <http://www.bondmarkets.com/assets/files/ECletter.pdf>

⁵ Almost 30% of issuers are the object of unsolicited ratings and almost 60% of investors rely on unsolicited ratings (See BMA Survey referenced above)



of conflict management and existing CRA business models, is undoubtedly one of the relevant causes. The agencies have generally responded to the challenge without severe disruption to the market; however, there is still an issue in terms analyst availability, at one of the agencies in particular.

Conclusion

Our feedback to CESR is overall positive. Significant improvements have been made by the agencies in several important areas, and most notably, in our experience, in communicating new or changing methodologies and in managing conflicts of interest. These improvements have been observed across all CRAs.

There is room for certain agencies to improve in certain specific areas, in particular those of unsolicited ratings disclosure, rating updates and consistent application of methodologies in certain sectors.

However, none of these issues has, in our experience, affected the ability by CRAs to continue to deliver quality ratings. We are strongly of the view that the approach summarised in paragraph 3 of this letter, and not regulation, is the correct way to ensure improvements continue to be made.

Finally, on the topic of structured finance which is not the primary focus of our working group but which we know to be of interest to CESR, we draw to CESR's attention a recent publication by the American Securitisation Forum (affiliated to the BMA) which contains policy recommendations on the use of ratings and rating agencies in the US securitisation market in the context of the current CRA legislative debate in the US⁶.

Yours sincerely,

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On behalf of:

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⁶ <http://www.americansecuritization.com/story.aspx?id=917> (press release)
http://www.americansecuritization.com/uploadedfiles/ASF_Recommendations_Credit_Rating_Agency_Oversight.pdf (Position paper)