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Committee of European Securities Regulators,
11-13 avenue de Friedland,
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Copy: commissioner McCreevy
(c/o Martin Power).

Monday March 31st 2008.

Consultation on the role of credit rating agencies in structured finance.

Response from

COLLECTIF POUR LA RECONNAISSANCE DU DEFAUT DE PAIEMENT RUSSE.

Dear Sirs,

Holders of defaulted sovereign bonds have known for a long time that the business model through which credit rating agencies (CRAs) are paid by the very entities whose issues they rate can cast serious shadows upon the quality of their ratings.

This had been very clearly pointed out by Mr. Helmut REISEN, head of OECD's research division as early as 1998: *"... Furthermore, the rating agencies derive most of their revenue from those states that use their services; they are therefore reluctant to downgrade their ratings. The fear of displeasing their clients and of witnessing a reduction in the demand for their services and in the associated revenue can lead to some rigidity in downgrading country ratings in times of excessive capital influx."*

In the second half of 2007 it became apparent that poor-quality housing loans had been repackaged and rated as investment grade obligations in massive quantities and unclear conditions.

Holders of defaulted sovereigns welcome the recognition, in the wake of the subsequent market turmoil, by regulatory bodies and investors worldwide, of the necessity to closely scrutinize the credit rating process for potential conflicts of interest.

They are, however, concerned to see that this scrutiny is mainly limited to potential conflicts of interest in the rating process of *structured products*, when other conflicts of interest have also been and are presently at work and influence the ratings of *sovereign issues* worth hundreds of billions of dollars.

COLLECTIF POUR LA RECONNAISSANCE DU DEFAUT DE PAIEMENT RUSSE will therefore be urging the European Commission, the Committee of European Securities Regulators, the International Organization of Securities Commissions, and other relevant parties to include the rating process of *sovereign issues* in the scope of their enquiries and studies.

With this in mind, I am sending you the attached document because I believe it can bring relevant information, pertaining to conflicts of interest affecting the ratings of *sovereign issues*, to those whose task it is to examine the actions of the credit rating agencies.

Yours truly,

Eric SANITAS

Embedded conflicts of interest within the recognized Credit Rating Agencies' business model and rating process:

A testimony from holders of defaulted Russian sovereign bonds.

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1. Identified conflicts of interest

- **Because ratings, as attributed by recognized credited rating agencies, are deeply relevant to the application of worldwide financial investment regulation, these agencies have in fact been handed an oligopoly;**
- **Because these agencies are paid by the issuers of the securities they rate, not by investors, they suffer a conflict of interest;**
- **And because their ratings are deemed mere opinions and thus protected as free speech, these agencies are unaccountable.**

Over the years, the main credit rating agencies have often come under very strong criticism in these respects. The ENRON debacle was just one case in point.

2. Habitual defense of CRAs

When they come under attack, one finds the CRAs habitually claim that although the ratings they attribute will reflect the information which has been disclosed to them, they cannot be held responsible for not reflecting any items which may have been withheld from them.

3. Testimony from the French: the Russian Federation is notoriously in default; yet it is rated "investment grade" by the three major CRAs

French holders of defaulted Russian bonds believe the CRAs' habitual defense as quoted in #2 above to be fallacious, and I would like to bring to your attention the very precise, verifiable and irrefutable instance of defaulted Russian bonds, because I believe it will prove my point.

I realize this instance might seem somewhat removed from the causes of the current market turmoil.

However I believe it stems from the very same conflict of interest which lies embedded in the rating process which has led to the unjustifiably inflated ratings which the main CRAs first attributed to many Collaterized Debt Obligations and various asset-backed securities before subjecting them to a sudden downgrading process, thus sparking the current sub-prime crisis.

Which is why I respectfully bring this instance to your urgent attention.

This instance lies in the unjustified "investment grade" rating attributed to the sovereign issues of the Russian Federation, a government which has consistently refused to honor the debt of its predecessor internationally recognized government prior to 1917, in flagrant violation of the *successor government doctrine* of settled international law.

Until October 24th 2007 - that is only five months ago - these bonds were continuously listed on the "Eurolist by Euronext" list of the regulated Paris exchange.

In 1999 a French government survey counted 316000 individual holders of these defaulted pre-1917 Russian bonds.

France's highest administrative court, the Conseil d'Etat, has repeatedly and recently found that the rights of bondholders against the Russian Federation are not extinct.

In a letter dated March 19th 2007 Mr. N. SARKOZY, today president of the French Republic, explicitly referred to this fact.

Independent experts have set the present value of monies outstanding at well above US$ 100 billion.

By refusing to settle its predecessor government's debt the Russian Federation has notoriously defaulted on its obligations, a default which has repeatedly and officially been notified to the main CRAs.

All three major agencies publish their rating rules and definitions; for example Standard and Poor's state, in particular, that their ratings are, among other things, an evaluation of the issuer's *willingness to pay* its financial obligations (see exhibit A), a *willingness* all too clearly absent in the case of the Russian Federation.

Indeed, while the Russian Federation punctually pays both capital and interest on modern-era Russian bonds listed on the Luxembourg exchange, it never has done so on pre-1917 Russian bonds, which have thus remained unserviced since 1918, despite the fact that no agreement has ever been reached with the bondholders and that the debtor is now notoriously affluent.

The CRAs have specific ratings for such circumstances.

Standard and Poor's call it "SELECTIVE DEFAULT" or SD: *"An obligor rated “SD” (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An “SD” rating is assigned when Standard & Poor’s believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner."* (exhibits B and D).

The above definition clearly applies to the Russian Federation; although Standard and Poor's will very probably remind us, through a disclaimer, that:

> ***"The sovereign is also regarded as having resolved its default in the rare instances, usually relating to a change in regime, in which governments repudiate certain types of obligations altogether and either reject creditor efforts to get compensation or, many years after the default, make token payments to creditors as settlement. Historic examples involving repudiations of foreign currency bonds include the Soviet Union in 1917, China in 1949, and Cuba in 1960. Had Standard and Poor's rated these sovereigns at the time, it would have lowered the ratings to "D" to reflect the debt repudiation. However, even if there is no resolution of a default through the courts or by the parties involved, Standard and Poor's***

> ***eventually removes the default ratings based upon the diminished prospects for resolution and the lack of relevance of the default ratings in the context of the market. Standard and Poor's forward-looking sovereign ratings typically refer only to debt that the present government acknowledges."*** **(exhibit C).**

Thus in one breath Standard and Poor's tells us that "*Sovereign credit ratings reflect Standard & Poor's Ratings Services' opinions on the future ability and willingness of sovereign governments to service their commercial financial obligations in full and on time"* (exhibit A), and in the next that *"even if there is no resolution of a default through the courts or by the parties involved, Standard and Poor's eventually removes the default ratings"* and that *"Standard and Poor's forward-looking sovereign ratings typically refer only to debt that the present government acknowledges."* (exhibit C).

In effect, Standard and Poor's are telling us that it is up to the sovereign debtor alone to determine whether he is under any obligation to pay.

The result of such policies is that despite its notorious default the Russian Federation has been attributed "investment grade" ratings by all three major agencies, instead of an obviously justified DEFAULT or SELECTIVE DEFAULT rating.

Indeed at one stage, while placing the ratings of the Russian Federation under review for possible upgrade, Moody's actually wrote that "*the* [Russian] *government's improved willingness and ability to meet its debt servicing obligations is matched by its improved willingness and capacity to increase tax collections and close tax loopholes*" (exhibit E); Moody's thus openly negates the Russian Federation's *un*willingness to face its internationally recognized obligations.

Yet Moody's is even less entitled than Standard and Poor's to make such a statement since, contrary to Standard and Poor's, it does dot make provisions by claiming to rate only that debt which is recognized by the present government.

Such contortions are injurious to the interests and protection of the investing community.

4. Investors suffer massive prejudice from attribution of unjustifiably high ratings

The natural inference from Standard and Poor's disclaimer is that in order to "*resolve its default*" all a unwilling revolutionary sovereign need do is repudiate his obligations, reject creditor efforts to get compensation, and wait until Standard and Poor's "*eventually removes the default ratings based on the diminished prospects for resolution*".

It must in addition be noted that the removal of the default rating, which Standard and Poor's claims to be justified by the "*diminished prospects for resolution and the lack of relevance*", is precisely what irrevocably leads to *"diminished prospects for resolution and lack of relevance"*, since the defaulted and *unwilling* debtor, who emerges from the process with a rating normally only associated with *willingness to pay*, is then in a position to tap international markets at the low cost normally only accessible to reliable borrowers without first settling outstanding obligations.

The end result of such a disclaimer is to negate both the *default* and the *unwillingness to pay* of a solvent debtor, although he has *defaulted* and is *unwilling* to pay, and to allow

the defaulted sovereign access to international markets on acceptable terms while consistently evading his existing repayment obligations.

By removing the only argument which could lead defaulted sovereigns to the negotiating table, CRAs deprives bona fide creditors of any means of making good on their bona fide claims, which they cannot, furthermore, take through the judicial system since sovereigns are mostly protected by sovereign immunity.

Surely regulatory bodies cannot simultaneously accept such practices and serve and protect bona fide investors' interests.

As stated above, in the case of the Russian Federation's rating the prejudice is well in excess of US$ 100 billion.

5. Rating policies viewed as disingenuous and fuelled by conflicts of interest

In view of the massive profits which CRAs stand to gain from attributing investment grade ratings to such defaulted issuers as the Russian Federation - as will be demonstrated below - bondholders view CRA justifications, disclaimers and policies with respect to the Russian Federation's ratings as disingenuous.

It has been made clear above that despite the argument they habitually put forth in their defense it is not through lack of knowledge, but on the contrary despite irrefutable knowledge of a default, and in violation of their own published criteria, that after considerable contortions the agencies have granted the Russian Federation what are in our view unjustified "investment grade" ratings instead of the deserved "default" ratings.

As a result, past, present and future investors are being very seriously misled on issues worth hundreds of billions of dollars, as they have recently been in the case of certain asset-backed securities.

Why is this so?

It is common knowledge that both public and private issuers from the Russian Federation have issued stocks and bonds in increasingly massive quantities over the past decade in international markets. Obtaining an investment grade rating is, for a new issuer, a prerequisite for any significant placing of bonds in international markets; therefore the prospect of these issues, particularly in bonds, has represented massive potential windfall profits for the agencies, whose revenue will in this respect be a percentage of the capital amount of the issues rated (In 2006 alone Standard and Poor's derived a massive US$ 1.52 billion in revenue from rating activities).

As is well known, it is not the ordinary custom for a rating agency to attribute a better rating to any private issuer of a given country than the rating attributed to that country's government.

French bondholders believe that therefore, had the agencies attributed to the Russian Federation government the "DEFAULT" rating it quite obviously deserves, the agencies would as a consequence have forfeited all the anticipated revenue stream from subsequent Russian issuers both public and private, since by virtue of the above custom these issuers would have been rated at best "DEFAULT" and could not, therefore, have accessed international markets; indeed they would have known they could not have borrowed a single dollar. Therefore they would not have requested ratings, and the CRAs would have been deprived of a revenue stream in the hundreds of millions of dollars.

We believe this conflict of interest to be endemic. In the case of sovereigns it develops with particularly disastrous results for the investor, since sovereigns are protected by sovereign immunity.

6. Need to revoke NRSRO recognition in the USA

It is both within the Securities and Exchange Commission's power and its mandate to revoke recognition from NRSROs who have engaged in wrongful practice.

COLLECTIF POUR LA RECONNAISSANCE DU DEFAUT DE PAIEMENT RUSSE will be writing to US authorities shortly.

7. Further need for regulation

We believe the mechanism described above is very similar to that which has led to the attribution of inflated ratings to collaterized debt obligations, and to the current sub-prime crisis; although its effects are far more harmful to the investor in the case of sovereign ratings, since the holder of defaulted sovereigns has no legal means of seizing any underlying assets through the courts, because of sovereign immunity.

In our view the actions of the credit rating agencies distort the true credit risk endemic to certain rated obligations, including sovereign obligations of the government of the Russian Federation, and thereby pose a hidden danger to European and foreign institutions and individual investors.

Holders of defaulted Russian bonds believe continuation of what they view as wrongful practices by the rating agencies, which directly contribute to misstatement of risks and resultant investor losses, is antithetical and inimical to the interests of the public, both in Europe and abroad. They believe unified legislation is warranted in order to remedy the continuation of practices described herein, provide relief to defaulted creditors from the injurious actions of the credit rating agencies, and preserve the integrity and transparency of international capital markets.

They strongly advocate for appropriate regulation of the CRAs in order to put an end to such questionable practices, so that the Russian Federation should be appropriately rated as a defaulted sovereign until full settlement of their claim, and so that other issues should not be attributed inflated ratings as a result of conflicts of interest similar to those described above.

I remain at your disposal to provide any documentary evidence as back up to the above statements and remain,

Sincerely yours,

Eric SANITAS
March 31st 2008

Exhibit A:

Extract from "Standard and Poor's criteria/Sovereign ratings: a primer":
"Sovereign credit ratings reflect Standard & Poor's Ratings Services' opinions on the future ability and willingness of sovereign governments to service their commercial financial obligations in full and on time."
(Full text at: www2.standardandpoors.com/spf/pdf/fixedincome/SovRatingsPrimer.pdf**)**

Exhibit B:

Extract from "Standard and Poor's criteria/Sovereign ratings: a primer":
"An obligor rated "SD" (Selective Default) has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An "SD" rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner."
(Full text at: www2.standardandpoors.com/spf/pdf/fixedincome/SovRatingsPrimer.pdf**)**

Exhibit C:

Extract from "Standard and Poor's criteria/Sovereign ratings: a primer":
"The sovereign is also regarded as having resolved its default in the rare instances, usually relating to a change in regime, in which governments repudiate certain types of obligations altogether and either reject creditor efforts to get compensation or, many years after the default, make token payments to creditors as settlement. Historic examples involving repudiations of foreign currency bonds include the Soviet Union in 1917, China in 1949, and Cuba in 1960. Had Standard and Poor's rated these sovereigns at the time, it would have lowered the ratings to "D" to reflect the debt repudiation. However, even if there is no resolution of a default through the courts or by the parties involved, Standard and Poor's eventually removes the default ratings based upon the diminished prospects for resolution and the lack of relevance of the default ratings in the context of the market. Standard and Poor's forward-looking sovereign ratings typically refer only to debt that the present government acknowledges."
(Full text at: www2.standardandpoors.com/spf/pdf/fixedincome/SovRatingsPrimer.pdf**)**

Exhibit D

Extract from "Moody's Sovereign Ratings: A Ratings Guide":
"What Do We Mean By "Default?
Moody's defines default as any missed or delayed disbursement of interest and/or principal. We include as defaults distressed exchanges where: (1) the issuer offers bondholders or depositors a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, debt with a lower coupon or par amount, or a less liquid deposit either because of a change in maturity or currency of denomination, or required credit maintenance facilities) and (2) the exchange has the apparent purpose of helping the borrower avoid default.
Moody's also classifies as a default when an issuer delays payment for credit reasons even when payment is ultimately made within the grace period provided for in an indenture or deposit agreement. Our rationale for including grace period defaults is simply that a contractual payment was not made when due.
It is important to keep this definition in mind, because many commentators use "default" in a much narrower sense, that is, in the legal context of a creditor actually declaring a debtor in default on a particular obligation, resulting in a judgment by a court in favor of the creditor. Anyone who examines the post-World War II period will quickly recognize the significant practical difference between what we mean by default, and what a judge might determine to be a default in a legal proceeding."
(Full text at:

www.moodys.com/moodys/cust/research/MDCdocs/09/2002500000424902.pdf?search=6&searchQuery=rating+policy&click=1)

Exhibit E

Extract from Moody's press release, September 8th 2005:
"The creditworthiness of the Russian Federation continues to benefit not only from growing revenues and foreign currency reserves flowing from high commodity prices but also from prudent fiscal management and proactive debt management. The government's improved willingness and ability to meet its debt servicing obligations is matched by its improved willingness and capacity to increase tax collections and close tax loopholes. State finances are, as a result, more secure."
(Full text at: www.moodys.com/cust/event/getdocument.asp?evdocid=2300000000043&event=2200000000102**)**