EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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via Email

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Consultation on CESR's technical advice on possible measures concerning Credit Rating Agencies (CESR/04-612b)

Response by EFFAS European Federation of Financial Analysts Societies

Dear Mr Demarigny,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 23 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management, Investment Advice.

Questions under I. Introduction.

Response to Question 1: EFFAS agrees with CESR's definition of Credit Rating Agencies.

Response to Question 2: EFFAS agrees with CESR's definition of credit ratings.

Response to Question 3: EFFAS agrees with the definition of unsolicited ratings.

Response to Question 4: EFFAS thinks that issuers should disclose rating triggers included in private financial contracts. Furthermore, EFFAS suggests the introduction of provisions which obligate institutional lenders to disclose their general policies on rating triggers employed in their lending contracts.

Response to Question 5: EFFAS thinks that the use of ratings in European legislation should be encouraged or made mandatory in bidding for contracts in the public sector. Ratings should be an element which enters into the criteria for selecting a contractor. Besides the price, the financial stability of a contractor is of prime importance.

Questions under II. Competitive Dimension: Registration and Barriers to Entry.

Response to Question 1: EFFAS thinks that there is presently not a sufficiently levelled playing field between CRAs. The barriers are not natural but rather created by the vicious circle produced by the existing oligopolistic structure in the industry. Furthermore, they are also created by the US national recognition system, while Europe is lacking any registration or recognition or regulation system. A European recognition system could balance high standards of recognition with a policy of promoting the entrance of new competitors into the market.

Response to Question 2: EFFAS believes that the coverage of SMEs is suboptimal. A proper structuring of a European recognition system with the admission of smaller agencies to cover SMEs could improve the coverage. This could be achieved by equity research firms expanding their activities into credit rating.

Questions under III. Rules of Conduct.

Interests and conflicts of interest

Response to Question 1: Overall, EFFAS agrees that the installation of procedures for the avoidance and management of conflicts of interests, the application of such procedures in each credit rating and the respective disclosure of such procedures and their application are appropriate and sufficient.

Response to Question 2: It is necessary to analyse the so-called ancillary services of a credit rating agency. Ancillary (or rather additional) services can be equity research on the rated issuer and other reviewing, controlling and evaluating services. Such additional services do not necessarily imply a conflict of interest whereas other paid services, advising the management of the issue or preparing and accompanying IPOs, search for investors etc., carry intrinsic conflicts of interests. EFFAS thinks that the latter services should be prohibited to CRAs. The second best solution remains establishing the obligation for the agencies to refrain from rating such issuers to which so-called ancillary services are or have been rendered. The third best solution is to disclose such ancillary services which give rise to conflicts of interest. If activities akin to rating (e.g. reviewing, evaluating) are permitted, a prohibition of other services would probably not create a relevant barrier to entry.

Response to Question 3: If the rating of structured finance comprises engineering of finance structures or individualised advice to the issuer to be rated beyond a general disclosure of the methodology employed for structured financing, such activity will give rise to conflicting interests insofar as the rating must make an assessment of the agency's own advice or engineering services.

Response to Question 4: See response to question 2.

Response to Question 5: EFFAS agrees that the disclosure of the fee scheme and its application as well as of policies and procedure mitigating conflicts of interest is sufficient. In an ideal world, a third party may pay the rating agency. This would create, however, other problems (bureaucracy, other conflicts of interest, no incentive to cover SMEs). Therefore, disclosure is the proper way.

Response to Question 6: EFFAS agrees that it is sufficient that the policies and measures with regard to issuing unsolicited credit ratings and the fact of a particular rating being unsolicited are disclosed. Unsolicited ratings should be encouraged. It could lower the entrance barriers. This issue is closely tied to the provision of information access through the requirement of data rooms.

Response to Question 7: EFFAS does not agree with the opinion that the disclosure of material, financial and other comparable links between a rating agency and an issuer are sufficient to adequately address the risk of biased ratings. The best solution is to avoid or eliminate such links. In cases where this is not possible, the rating agency may not rate this particular issuer. Disclosure is only the third ranking solution to cope with the potential bias.

Fair presentation

Response to Question 1: EFFAS does not agree that credit rating agencies should only introduce policies and measures managing and disclosing levels of skills of staff unless such management includes a training of staff members to maintain and improve the necessary skills. The training practice and the qualification of the staff employed in a particular rating should be disclosed.

Response to Question 2: Mandatory training (see response to question 1). In a system subject to government recognition or regulation, the lack of sufficient skills or the existence of inappropriate skills may only lead to a withdrawal of such recognition. Last but not least, the market will police the quality of credit rating agencies when and if there is sufficient competition.

Response to Question 3: EFFAS thinks that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings.

Response to Question 4: EFFAS sees more disadvantages in the regulation of CRA's methodologies by regulators. The only advantage of such regulation would be uniformity of methodologies applied, provided the regulators could agree on the respective methodologies to be applied. Disadvantages are manifold. Regulators would have to build up an expensive bureaucracy to formulate or select and prescribe methodologies. Uniformity of methodologies would carry the risk of ossification of such methodologies. This would hamper the development and refinement of such methodologies according to the need of industries and users. Different types of issuers might require different methodologies. Regulators could and would only react late to such requirements. Regulators will already have a role in this process to a certain extent by their involvement under the capital adequacy rules of credit institutions. This should suffice. The development and discussion of methodologies should be left to the industry and market organisations and academia.

Response to Question 5: EFFAS believes that the IOSCO Code provisions are sufficient in terms of rules on methodologies and the corresponding disclosure. EFFAS believes that before starting to use new methodologies credit rating agencies should disclose changes in methodologies not only to the issuer but - in line with the IOSCO Code rules - also to the public, i.e. users.

Response to Question 6: EFFAS believes that regulation should not concern all aspects of methodologies. The disclosure and summarising explanation of the key elements and assumptions of a rating should be required, as well as the disclosure of the updating policy. Regulators should not require a particular kind of sensitivity analysis. The application of such an analysis, if any, should be part of the summarising disclosure. Benchmarking should not be mandatory. These issues should be a topic to be addressed by the industry organisations.

Relationship between issuers and rating agencies.

Response to Question 1: EFFAS considers the combination of the requirements of the Market Abuse Directive and the requirements of the current version of the IOSCO Code adequate to address the issue of access to inside information by the credit rating agency.

Response to Question 2: In EFFAS' view, an issuer should not be required to itself disclose an imminent rating change where it has obtained prior knowledge of this regardless of whether or not this knowledge amounts to inside information. First: EFFAS believes that the decision to change a rating should not be discussed between rating agency and issuer, only the correctness of the underlying facts should be discussed. Second: The time and form of announcement are the prerogative of the credit rating agency. This announcement may have to be accompanied by disclosures to be made and information given by the agency, in order to be fully understandable. This process might be materially distorted by a unilateral announcement by an issuer privy of the fact of a rating change. This does not affect the treatment of this fact as inside information by and for the issuer and the credit rating agency.

Response to Question 3: EFFAS considers that the requirements of the Market Abuse Directive in this area sufficiently address the risks of handling such inside information.

Response to Question 4: In order to create a level playing field between credit rating agencies with regard to issuers' information, the discussion of the mandatory establishment of a data room is relevant. A data room accessible to all interested credit rating agencies is incompatible with the protection of inside information. This means in practice, inside information of an issuer should be made public and lose the quality of inside information before it is made available in the data room. If this is not possible or advisable for the issuer, the issuer should withhold such information from all competing agencies alike. An exception may be made in those cases where only one agency has shown interest in covering the issuer in question because there is no competition.

Response to Question 7: Issuers should be entitled to check the accuracy of the factual assumptions made by the credit rating agency. They should not be involved in the assessment of judgement leading to the rating grade.

Response to Question 8: An issuer should not have a "right of appeal" beyond the legal and procedural tools provided under contract or tort law against malpractice in the respective jurisdictions. The discussion would have to address the question of "appeal to whom". Nobody hinders the issuer addressing the credit rating agency and advancing the issuer's views on the matter. But a formal appeal assumes a procedure with rights and obligations. To develop any such system should be left to the industry and their organisations. They might introduce a mediation or conflict settlement body. Such mediation or settlement can, however, only be after the fact and not before a rating is issued, lest the rating process be obstructed.

Response to Question 9: EFFAS considers the provisions of the current Draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by the credit rating agency is accurate.

Response to Question 10: EFFAS thinks that no specific measures are necessary to require a minimum of archiving. The appropriate time frame for keeping records supporting a rating is the prescription or stature of limitation period provided in the respective jurisdictions during which an agency might be held responsible by an issuer for malpractice. Within this period, the credit rating agency should bear the burden of substantiating and proving the basis for its rating.

Response to Question 11: This question cannot be answered in a uniform manner. For large issuers, attracting the interest of several rating agencies, it would be appropriate to mandate the establishment of a data room allowing access to all agencies and providing equal opportunity to obtain factual information. This should, however, not be mandatory for SMEs. The organisational and consequently financial burden for such enterprises is too high to warrant such a requirement. With few exceptions, such enterprises will not be covered by several agencies. No general need for a data room exists.

Questions under IV. Regulatory Options concerning Registration and Rules of Conduct for Credit Rating Agencies.

Response to Questions 1 and 2: EFFAS prefers a lighter registration/regulation regime essentially based on the IOSCO Code which would also encompass recognition under the Capital Adequacy Directive. This light regulation/registration would be supplemented by a monitoring through industry bodies. The governmental regulators should restrict themselves to a monitoring of the market developments and should police abusive practices on a case by case basis.

Pros and cons for full registration /regulation:

Pro: Uniform rules and hopefully also enforcement of such rules. Governmental force. Would make separate recognition for capital adequacy purposes unnecessary.

Contra: Excessive cost. Excessive bureaucracy. Inflexibility. Raising the entry barrier for small and middle sized rating agencies.

Pros and cons for light registration/regulation

Pro: Governmental authority. Government competence to address abuses. Less bureaucracy for case by case policing. Delegation of powers could be made to bodies with issuer and user participation. No necessity for additional recognition for capital adequacy purposes. Enhanced reputation of industry. Might lower entry barrier by conveying market confidence. Facilitating cross border business. Mutual recognition possible (European Passport).

Contra: Some abuses might go undetected from time to time.

Assessing compliance to IOSCO Code Fundamentals in a parallel process to recognition under the Capital Adequacy Directive

Pro: If light recognition instead of light regulation, all pros for light regulation apply. Might lower entry barrier.

Contra: If recognition means an additional process, the negative aspects outweigh any advantage. Double cost, double bureaucracy, diminishing the acceptance of one of the licenses. Accumulating market entry barriers.

Third party's certification of enforcement of the IOSCO Code.

Pro: More flexibility, speed. Possibly less costly.

Contra: No government authority. Market acceptance doubtful. Governmental oversight and monitoring indispensable. Will only function in combination with regulation light.

Rules covering only specific aspects of credit rating agencies' activities.

Pro: Least expensive solution. Market forces are not inhibited.

Contra: No enforcement. Rules will only be observed as long as markets force their observance.

Monitoring the market development

Pro: Necessary under all policy options.

Contra: If stand alone, monitoring market development is no policy at all. It amounts to inactivity. Will not lower the entry barrier due to the lack of government approval and confidence building.

Response to Question 3: EFFAS thinks that the IOSCO Code of Conduct is conducive to increasing competition because it gives a framework which will apply regardless of which policy option is chosen, with the exception of the mere monitoring of market development.

Response to Question 4: At the present time, EFFAS sees no relevant areas in which the European rules of conduct should be extended beyond the IOSCO Code. The main issue is the policy through which the rules are enforced.

Response to Question 5: A fully joint treatment of rating agencies by banking and securities regulators is not only desirable but indispensable. Only such treatment would allow a single regulation/registration/recognition procedure.

Yours sincerely,

Fritz H Rau
Chairman of EFFAS