



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

CESR
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EFFAS on the Consultation on The role of credit rating agencies in structured finance

Dear Sirs,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 25 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management as well as Investment Advice.

The EFFAS Market Structure Commission (MSC) is a standing commission of experts under the aegis of EFFAS.

We have been repeatedly approached by CESR and national regulators in context with the question whether and to what extent a regulation of Credit Rating Agencies (CRAs) may be required. We are pleased to comment on the consultation on the role of credit rating agencies in structured finance which was published on February 13, 2008. In general, we support the position of the CESR presented in the consultation paper. It is our belief, though, that CRAs deserve the same level of regulation as is already established for investment research. To further represent our point of view, we will first provide some general comments and remarks on selected subjects, and second provide the direct answers to CESR's questions.

1. General comments on core subjects

▪ Conflicts of interest

We regard the direct interaction between issuer and CRA as observed in structured finance as a potential for conflicts of interest. In principle, CRAs should thus be required to indicate if the rating of an issue is the result of an interactive process involving the issuer or not.

In particular, we can see potential conflicts when the fees paid to CRAs are made dependent on the size of the issue, respectively the demand of investors for the product. It can be assumed that this demand will in general be higher when – everything else being equal – a rating is more favourable for the product.

▪ ***Transparency and Monitoring***

We do agree with CESR and most market participants that over-regulation should be avoided. We would propose, however, to differentiate between the regulation of a product or a methodology of analysis on the one hand, and the regulation of sales procedure of a product on the other hand. While the former clearly bears the risk of over-regulation and should thus be avoided, the latter would be better suited to ensure efficient functioning of the market when self-regulation does not fully work.

We therefore propose that CRAs should come under regulation with respect to the dealings with conflicts of interest, and also for principles to disclose methodologies applied in order to overcome information asymmetries. For the latter purpose, we have developed Standards for Rating and Validation, which we had submitted to CESR in earlier consultations.

▪ ***Relevance of Exemptions from the Market Abuse Directive***

Financial research is subject to regulation under the Market Abuse Directive 2003/6/EC and the Implementing Directive 2003/125/EC as well as under the Markets in Financial Instruments Directive 2004/39/EC and the Implementing Directive 2006/73/EC.

As ratings are assumed to be designed purely to represent the likelihood of default of the financial instrument rated, CRAs are explicitly exempted from the Implementing Directive 2003/125/EC. It is stated in recital 10 that “Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument as of a given date. As such, these opinions do not constitute a recommendation within the meaning of this Directive. However, credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they appropriately disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate.”

We agree, however, with CESR with its observation given in the Background section of this consultation under point # 57 that “the rating process for structured finance also held similarities to corporate finance”. We also agree with the statement in the BIS report that “a number of investors claim to rely almost exclusively on the rating agencies”. We therefore conclude that, in the case of rating structured finance products, the exemption of CRAs from this Directive should not be applied, and that recital 7 should come into force here as well: “Personal interests or conflicts of interest of persons recommending or suggesting investment strategy may influence the opinion that they express in investment recommendations. In order to ensure that the objectivity and reliability of the information can be evaluated, appropriate disclosure should be made of significant financial interests in any financial instrument which is the subject of the information recommending investment strategies, or of any conflicts of interest or control relationship with respect to the issuer to whom the information relates, directly or indirectly.”

2. Answers to CESR’s questions

Q. 80: Do you agree that the CRAs need to make greater on-going efforts to clarify the limitations of their ratings?

Yes, we agree.

Q. 90: Do you agree with CESR's view that although there has been improvement in transparency of methodologies, the accessibility and content of this information for complex structured finance products requires further improvement in particular so that investors have the information needed for them to judge the impact of market disruption on the volatility of the ratings?

Yes, we agree.

Q. 97: Do you agree that there needs to be greater transparency regarding the specific methodology used to determine individual structured finance ratings as well as rating reviews?

Yes, we agree. Here we want to refer to our published detailed Rating and Validation Standards.

Q. 100: Do you agree that there needs to be greater public and standardised information on structured products in the EU? How would this best be achieved?

Yes, we agree.

Q. 104: Do you agree with CESR that contractually set public announcements on structured finance performance would not add sufficient value to the market to justify the cost and possible saturation to the market with non-material information?

Yes, we agree.

Q. 112: Do you agree that the monitoring of structured finance products presents significant challenges, and therefore should be a specific area of oversight going forward? Are there any particular steps that CRAs should take to ensure the timely monitoring of complex transactions?

We agree with the monitoring of Conflicts of Interest, not with the monitoring of Rating methodology.

Q. 118: Do You believe that the CRAs have maintained sufficient human resource, both in terms of quality and quantity, to adequately deal with the volumes of business they have been carrying out, particularly with respect to structured finance business?

We cannot comment on human resource of CRAs in detail but we want to point out that the qualification of rating analysts is a key element for the assurance of high quality analysis.

Q. 120: Do you consider that the generally unaltered educational and professional requirements of CRAs recruitment policies negatively impact the quality of their rating process, given the rising complexity of structured finance products?

No comment.

Q. 125: Do you agree there is a need for greater transparency in terms of CRA resourcing?

No comment.

Q. 126: Do you agree with CESR that more clarity and greater independence is required for analyst remuneration at the CRAs?

Yes, we refer to our argument made on conflicts of interest with regard to certain fee structures given in the first section.

Q. 133: Do you see the level of interaction between the CRAs and issuers of structured finance products creating additional conflicts of interest for the CRAs to those outlined above? Do you believe that any of these conflicts are not being managed properly?

We think that regulation should also reflect incentive structures.

Q.134: Do you agree that greater transparency is required regarding the nature of interaction between CRAs and issuers/arrangers with regards to structure finance products and that there needs to be clearer definitions of acceptable practice?

Yes, we agree, see our remarks in the first section.

Q. 138: Do you believe there needs to be greater disclosure by CRAs over what they consider to be ancillary and core rating business?

Yes, we agree.

Q. 142: Do you believe that the fee model used for structured finance products creates a conflict of interest for the CRAs? If yes, is this conflict of interest being managed appropriately by the CRAs?

Yes, we believe the fee model to be a likely source of conflicts of interest for the CRAs. The minimum reaction when dealing with this conflict would be a full and detailed public disclosure.

Q. 146: Do you agree with CESR that there needs to be greater disclosure of fee structures and practices with particular regard to structured finance ratings so as to mitigate potential conflicts of interests?

Yes.

Q. 164: Do you agree with CESR's view of the benefits and costs of the current regime?

Yes, we agree with the observation of the issues.

Q.170: Do you agree that CESR has correctly identified the likely benefits and costs related to formal regulatory action?

We agree that the identification of the likely benefits and costs by CESR is correct. See also the answer to the following question.

Q. 177: Do you believe that the current self-regulatory regime for CRAs should be maintained rather than introducing some form of formal recognition/regulation?

No. We would propose a regulation of conflicts of interest and transparency issues rather than self-regulation in these cases. We agree with the notion that methodologies applied by CRAs and processes except the ones bearing conflicts of interest and information asymmetries should not be regulated.

Yours sincerely,



Fritz H. Rau
Chairman of EFFAS



Giampaolo Trasi
Chairman of the EFFAS MSC