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Fabrice Demarigny
Secretary General
Committee of European Securities Regulators
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Comment on CESR's Consultation Paper on possible measures concerning Credit Rating Agencies

Dear Mr. Demarigny,

The International Banking Federation (IB*fed*) welcomes the opportunity to present its views on the draft technical advice that CESR proposes to give to the Commission.

IB*fed* is the representative body for a group of key banking associations. Its members are the banking associations of Europe, the United States, Australia and Canada. The objective of IB*fed* is to increase the effectiveness of the financial services industry's response to multilateral and national government issues affecting their common interests. The federation, which is based in London, became operational on 30 March 2004.

Please find below our reflection on your analysis and the policy options you are considering.

Banks are key users of ratings, be it as arrangers, investors or issuers. They have a genuine interest in high-quality, consistent ratings. The value of the ratings must be regarded as *the* most important objective. There is, however, no evidence that the main agencies are not producing such ratings. Potential shortcomings of CRAs would trigger swift reactions by markets as rating is a highly sensitive business. We therefore believe that proper conduct by CRAs can be assured through **self-regulation**. Such self-regulation must ensure that the level of disclosure required allows transparency of practices to the market. Given that IB*fed* favours self-regulation, we consider that **CRAs should not** become **regulated** bodies.

1. The right reference for regulation

IOSCO Code of Conduct - the appropriate reference

CESR rightly starts its consultation paper pointing out that The International Organization of Securities Commissions (IOSCO) has recently developed a comprehensive Code of Conduct.[1] Called the "Fundamentals of a Code of Conduct for Credit Rating Agencies" (hereafter IOSCO Code), the document describes provisions that rating agencies should incorporate into their own codes of conduct to deal with issues such as how rating agencies should avoid or mitigate potential conflicts of interest, improve the transparency of the ratings process, and protect their integrity and independence while dealing fairly with issuers, investors and other market participants.

The IOSCO Code obliges CRAs not only to incorporate its provisions into their own codes of conduct, but also to explain how each provision is addressed. If a particular provision of the Code is not incorporated into the CRA´s own code of conduct, the CRA is expected to disclose this fact, explain why it has not incorporated the relevant provision, and how the objectives of that provision are otherwise addressed. Market participants will then be able to judge for themselves whether each CRA has implemented the Code satisfactorily and react accordingly. This IOSCO Code offers the necessary degree of flexibility to rating agencies, which vary considerably in size, business model, and development of the markets in which they operate.

IOSCO expects all rating agencies will incorporate and give full effect to in their codes of conduct. The European securities regulators can therefore expect that all CRA that are active on European markets will consider this Code as a point of reference for their own behaviour.

We equally regard the IOSCO Code as the future common and worldwide standard. The fundamental requirements are strict but coherent and overall appropriate.

- **We therefore strongly urge EU authorities to rely as much as possible on the IOSCO Code and refrain from establishing additional and possibly conflicting criteria applicable within the European Union only.**

The CESR Consultation Paper refers to cooperation between CESR and CEBS regarding the Capital Requirements Directive. This cooperation is of utmost importance to industry:

- **There must be coherence and consistency between the recommendations of CESR, the work being carried out globally and the principles for recognition of ECAIs being developed by CEBS.**

Finally, it is important for CESR to take account of any action taken in other jurisdictions.

- **European financial markets must not become less attractive to any market participants as a result of over-prescriptive measures**.

No prescriptive rules on methodologies and/or processes

Objectivity, independence, credibility and transparency are all targets a code must address as it is in fact done with the IOSCO Code. However, any attempts to prescribe in great details methodologies and/or processes CRA are likely to compromise the independence of rating agen-

[1] The International Organisation for Securities Commissions (IOSCO): Code of Conduct Fundamentals for Credit Rating Agencies (http://www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf. The Code was released 23 December 2004.

cies, reduce innovation and the quality of the process. All that would have a detrimental effect on the quality of information flow in securities markets.

Market mechanisms preferred over regulatory oversight or arbitration

The question remains whether some supervision of the IOSCO Code is needed or desirable. With regard to compliance we favour a market driven solutions such as the mentioned IOSCO Code or similar procedures over regulatory oversight or arbitration. In the following section we will argue why any additional criteria and/or formal registration of CRA would increase regulatory burden for CRA without necessarily contributing to increased transparency, quality and reliance.

2. Strengthen the status of a Code?

There are different ways to strengthen the status of a Code. The strongest option would be to give it some law-based status. Law-based provisions are binding by definition because of their legal status. That does however not mean that standards, such as the IOSCO Code, are voluntary. Complying with standards can in fact be strictly required to be active in a specific market due to peer or market pressure. Hence, one should not associate strictness with public rules and laxity with standards.

The most visible international financial standards are those developed by the specialist groups of supervisory authorities, such as for instance IOSCO. Their standards are usually much more than a minimum common denominator of existing national requirements. By contrast, the most advanced standards may go beyond some national requirements; the main example being the first Basel Capital Accord.

The use of standards can in some cases be the only tool available: As there is no formal legal structure in place at world level, self regulation, such as the IOSCO Code, is an effective tool to co-ordinate the policies vis-à-vis CRA. Codes can develop into an effective form of governance, serving as a substitute for public regulation.[2]

It is true that the rating industry is dominated by three large suppliers. The Code needs therefore not to be addressed to thousands of entities as it is the case in other fields of self-regulation: There are roughly 50 CRA worldwide, most of them highly focussed on specific markets or segments of securities, with less than a dozen active within the EU; only the “big three” are active in all EU Member States. The limited number of CRA greatly facilitates assessing the behaviour of individual firms as well as the industry.

However, to gather from this that there is (too) little competition in the market for CRA would be wrong. The oligopoly structure of the industry rather reflects the nature of the business than political shortcomings. In fact, why should an issuer pay yet another, new and therefore little known agency to get his debt rated? To be successful in the rating business (and that means to be observed) an agency needs above all credibility and reputation; both qualities that may well take years to acquire: Therefore the high entrance barriers and consequently the few competitors. Any prescriptive measures on CRA would in fact privilege existing CRA further at the cost of potential new entrances.

Yet the main reason why we strongly believe that an “upgrading” to law-based provisions is neither needed nor appropriate is another: CRA are commercially run enterprises, their reputation and ultimately their success is at risk should markets, customers or competitors come to belief that they are not living up to self-commitment and best practice market standards. Potential sanctions taken by markets will in most cases be more intimidating than those at the

[2] The Investment Services Directive contains an express clause allowing the delegation of regulatory and supervisory responsibilities to regulated markets.

disposition of authorities. The threat of losing reputation, actual and future clients is the ultimate reason to comply with well-established standards.

We do not think requiring rating agencies to register with some public agency would be helpful, no matter whether such a scheme would be limited to the IOSCO Code or extended to more specific rules. The creation of any kind of European Registration System would introduce yet another regulatory layer for CRAs in the European Union, in addition to the recognition system currently proposed in the context of the Capital Requirements Directive (see below). There would be at least a partial duplication of accomplishments, controls and flows of information. Such duplication would increase the regulatory burden for CRAs. They would have to deal with two information flow requirements and two authorities. The presence of two regulatory systems could even increase barriers to entry in the ratings market for newcomers.

Finally it is important to remember any registration would be limited to some jurisdiction and that rating is a more international business than any other in the financial industry. Large CRAs often rate companies cross border in countries where they are not physically present.

3. No third party's certification

Another way to strengthen the status of the Code could be some form of market-based means of certification without participation of the public sector. For instance an arbitration court could judge whether a rating agency complies with the Code or the auditors of a particular agency could give their view on compliance.

It is not evident that a third party's certification would contribute to a better enforcement in any way; it would merely shift the task to a third party, creating yet another and new subject playing a regulatory role while leaving the question "who is verifying the verifiers?" open.

4. IOSCO Code as benchmark for Capital Requirement Directive recognition

A third way of enforcing the IOSCO Code could be to asses it in parallel to the Capital Requirement Directive (CRD) recognition process.

The draft CRD provides for the use of external credit assessments in the determination of the risk weights (and consequential capital requirements) applied to a bank or investment firm's exposures. Only the use of assessments provided by recognised External Credit Assessment Institutions (ECAIs) will be acceptable to the Competent Authorities ("CAs"). A recognition mechanism is therefore outlined in the draft Directive. CEBS is expected to release shortly a paper on the recognition of ECAIs.

The objective of the CRD recognition is to assure that external ratings used are objective and of high quality. Wide areas covered in the IOSCO Code are relevant for CRD as well: objectivity, independence, credibility and transparency. That does not mean that finally all material standards will be the same. Nevertheless, it is worth assessing the elements in the Code of Conduct through the CRD recognition process in parallel. As being compliant with the IOSCO Code will become part of any sound rating business, it is be reasonable to assume that the same soundness is demanded from any institution that the public sector relies on for regulatory purposes. This would also help authorities to approach particular issues consistently. One should therefore consider using the IOSCO Code as a benchmark for the CRD criteria to the greatest possible extend.

This process will, of course, only cover those rating agencies that want to be recognized for external ratings. However, it can be expected that at least the large and globally active CRAs will all take part in this process.

5. Conclusion: Give IOSCO Code of Conduct a chance

It would be appropriate to allow some time for the IOSCO Code to be implemented and then make a judgement about whether the Code is effective enough and implemented properly by market participants.

The IOSCO Code, together with the EU Market Abuse Directive as far as applicable, build a sound base to assure the integrity of the rating process while, at the same time, maintaining a degree of flexibility to deal with the different legal and market circumstances in which CRA operate within the EU and worldwide.

Relying at least for some time on, what can be considered an effective process of self regulation is worth while. This should also be seen in a wider perspective: One of the proclaimed aims of the EU summit meeting in Lisbon in 2000, which has been confirmed since on numerous occasions, was to ensure that the benefits of greater competitiveness are transferred to citizens and businesses. Reducing, and at least not imposing, further the burden of regulation is one of the effective instruments available to achieve this.

We are grateful for having had the opportunity to comment on the consultation paper and hope that our comments will be taken into consideration.

Yours faithfully,

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