Investment Management Association
ima

1 February 2005

M. Fabrice Demarigny
Secretary General
CESR
11-13 Avenue de Friedland
Paris
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Dear M. Demarigny

CESR's Technical Advice to the European Commission on Possible Measures concerning Credit Rating Agencies Consultation Paper

The IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

The IMA appreciates the opportunity to respond to CESR's Consultation Paper seeking comments on the draft technical advice that CESR proposes to give to the European Commission. The importance of credit rating agencies (CRAs) to fund managers is growing as corporate debt displaces equities in portfolios. Increasingly credit ratings are being relied upon to describe asset allocation in client mandates or fund definitions, as well as regulators adopting ratings into some of their rules, which means they have a considerable interest in transparent and robust practices. The IMA would strongly encourage close collaboration with the US Securities and Exchange Commission and with IOSCO. We do believe that the role of regulators should be to encourage transparency and the development by rating agencies themselves of proper procedures to deal with the issues raised.

The key point which the IMA wishes to make is that credit ratings are merely an opinion, and we think that it is important for the credit analyst to be able to adapt to changing circumstances. The more weight that is put on an opinion, the more difficult it is for the credit analyst to change, thus slowing down opinion forming.

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The IMA believes that any form of registration/regulation will raise barriers to entry and that it should be the role of the regulator to encourage more competition with respect to credit ratings assessments. More competition in the ratings' process will encourage a higher level of analytical input and thereby improve the quality of ratings overall.

With respect to conflicts of interest, the IMA believes that CRAs should put in place policies and procedures to identify, manage and disclose those conflicts inherent in their individual business models and that those policies should be publicly disclosed. The IMA also encourages CRAs to disclose all group-wide links to its issuer client base.

The IMA also would welcome efforts to enhance the transparency of the credit rating process and the publication of the CRA's methodologies. This would go part of the way to resolving the issue of the dependency of the rating agency on unverifiable or non-public information that is not available to the investor and therefore is unverifiable. The temptation must be for the CRA to establish a credible rating so that a bond can be issued rather than to challenge the veracity of the information, which the fund manager would do as part of his due diligence.

The IMA urges that CESR does not bring CRAs into its regulatory oversight or supervision. As noted above credit ratings are merely opinions and there will be a range of opinions in the wider market about any borrower or bond. This leads to healthy markets. There is a real danger of the investor being misled as to the quality of a rating if there appears to be some formal regulatory "endorsement" of the CRA. The IMA encourages CESR to require CRAs in Europe to adopt the IOSCO Code of Conduct Fundamentals as a self-regulatory regime. This Code has the advantage of being globally acceptable, having the flexibility to adapt to different business models as well as allowing for future market developments, and is appropriately robust and transparent.

We hope that these comments are helpful. Should you like to discuss any of these points further, then please do not hesitate to contact me.

Yours sincerely,

Elizabeth C Rae

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Consultation Paper's Questions

I Definitions, Use of Ratings in Private Contracts in Europe and Use of Ratings in Legislation in Europe

Questions

1. Do you agree with the definition of credit rating agencies? If not, please state your reasons.
   Agree. If ECAIs are already subject to recognition by Competent Authorities as eligible to provide credit assessments with respect to the Capital Requirements Directive, then there is no need to subject them to further scrutiny. It does however leave "non-eligible" ECAIs outside of any potential regulatory regime.
2. Do you agree with the definition of credit ratings? If not, please state your reasons.
   Agree.
3. Do you agree with the definition of unsolicited ratings? If not, please state your reasons.
   Agree.
4. Do you think that issuers should disclose rating triggers included in private financial contracts?
   Yes. These triggers may have a material effect on an issuer's ability to service its public debt.
5. Do you think that the use of ratings in European legislation should be encouraged beyond the proposed framework for capital requirements for banks and investment firms? If yes, please provide examples.
   No. The more importance placed on, and wider usage of, CRA assessments and opinions by legislators and regulators, the more ratings will be viewed by investors as an "endorsement" of a particular security or issuer. In addition, the more weight that is put on that opinion the more difficult it is for the credit analyst to change, thus slowing down opinion forming. The IMA makes the point again that credit ratings are merely opinions and that there will be a range of opinions in the wider market about any borrower or instrument.

II Competitive Dimension: Registration and Barriers to Entry

Questions

1. Do you think there is a sufficiently level playing field between CRAs or do you think that any natural barriers exist in the market for credit ratings that need to be addressed?
   The IMA believes that the playing field between CRAs is reasonably level, although the introduction of the CRD and a system of recognition will have the effect of raising barriers to entry. The IMA is not convinced that size is a particular issue, at least with respect to investors. There would appear to be no reason why a small, niche CRA should not be successful in establishing a proven track record. There are plenty of examples of independent, small equity research companies, which have succeeded in carving out a niche

market for themselves, and there does not appear to be any reason why that model should not be adopted by CRAs. While it is understandable that issuers may prefer to be rated by one of the large, globally recognised CRAs, it is not inconceivable that some issuers may even prefer to be rated by a specialist CRA rather than a large, multi-functional one. The less regulation, and the less that regulators rely on CRAs' ratings, then the easier it will be for entry barriers to be lowered.

2. Do you believe that coverage of certain market segments or certain categories of economic entity (such as SMEs) may be sub optimal? Are there measures that regulators could use to effect this scenario? Which are they, and would it be appropriate to use them?
   It would appear that the coverage of some market segments, such as SMEs, is sub-optimal. The best way to address this shortfall would be to reduce regulation and thereby barriers to entry, and let market mechanisms provide a solution. There is no evidence of a market failure.

III Rules of Conduct Dimension

Interest and Conflicts of Interest
Questions

1. To what extent do you agree that in order to adequately address the risk that any conflicts of interest might adversely affect the credit rating it is sufficient to have the credit rating agency (i) introduce and disclose policies and procedures for management and disclosure of conflicts of interests, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?
   The IMA agrees that processes and procedures for the identification, management and disclosure of conflicts of interest should be made public. It is not necessary for it to be disclosed for each rating, unless in a specific case the CRA has not complied with its own policies.
2. Do you consider that to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is necessary to prohibit a credit rating agency from carrying out those services? If your answer is yes, how would you address the entry barriers that could be created by imposing such a ban?
   No. CRA disclosure of the provision of those ancillary services to specific issuers is sufficient and proportionate.
3. Do you think that structured finance ratings give rise to specific conflicts of interest that should be addressed in CESR's advice to the Commission?
   No. Whatever conflicts arise out of providing additional services to a client should be managed within the CRA's published processes and procedures for managing conflicts of interest and not treated as a separate issue.
4. To what extent do you agree that in order to adequately address the risk that the provision of ancillary services might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce and disclose policies and measures managing and disclosing multiple business relationships with issuers in general and the issuer being rated in particular, and (ii) disclose whether the said policies and procedures have been applied in each credit rating?
   (i) is sufficient. (ii) should only apply on an exceptions basis.

5. To what extent do you agree that in order to adequately address the risk that an issuer paying for a credit rating might influence its rating it is sufficient to have the credit rating agency (i) introduce policies and procedures, including but not limited to the introduction of a fee scheme, (ii) disclose its fee scheme and (iii) disclose whether the fee scheme has been applied in each credit rating?
   The CRA's fee charging policy is a matter of commercial sensitivity, although there is an inherent divergence of interest between the CRA and the issuer as CESR points out. The CRA's policies and procedures with respect to this specific conflict should be made public without damaging its commercial interests.
6. In order to deal with issues related to unsolicited ratings, to what extent do you agree that is sufficient to have the credit rating agency (i) introduce and disclose policies and measures with regard to issuing unsolicited credit ratings and (ii) disclose when a particular rating has been unsolicited?
   Both (i) and (ii). While the issue of unsolicited ratings can have a distorting effect on the market, it is better that the market knows that the rating is unsolicited than not, and makes for better transparency.
7. To what extent do you agree that in order to adequately address the risk that any financial or other link between a credit rating agency and an issuer might influence the credit ratings process it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing financial links or other interests between a credit rating agency and issuers or its affiliates or investments in general and the issuer or its affiliates or investment being rated in particular, (ii) disclose the said policies and procedures and (iii) disclose whether the said policies and procedures have been applied in each credit rating?
   The CRA should introduce policies and measures to manage and disclose financial links or other interests between a credit rating agency and any issuer or its affiliates or investment being rated. Disclosure of such links should be made with each credit rating.

Fair Presentation
Questions

1. To what extent do you agree that in order to adequately address the risk that lack of sufficient or inappropriate skills might lead to poor quality credit ratings it is sufficient to have the credit rating agency (i) introduce policies and measures managing and disclosing levels of skills of staff, (ii) disclose the said policies and measures and (iii) disclose whether the said policies and measures have been applied in each credit rating?
   Commercial interest will drive CRAs to ensure that it has the appropriate level of skills amongst its staff. In order to retain and win business a CRA has to demonstrate a good track record of credit ratings. This can only be achieved if the CRA has sufficiently skilled analysts. To introduce and disclose policies measuring and managing levels of skills is too onerous. It may be appropriate, however, to publish the CVs of the CRA's analysts on its web site.

2. Do you have any alternative approaches to address the actual or potential risk that lack of sufficient or inappropriate skills might lead to poor quality credit rating assessment?
   Market forces and commercial interests will address any shortfall in the skills level of individual credit analysts. It is in the CRA's own interest to ensure that it has sufficient resources to carry out high-quality credit assessments.
3. Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?
   Not necessarily, but it would make the credit rating process more opaque to investors. The IMA believes that it is desirable that CRAs publish their rating methodologies in order to enhance the transparency of the rating process. This would go part of the way to resolving the issue of the dependency of the rating agency on unverifiable or non-public information that is not available to the investor and therefore is unchallenged.
4. Do you see more advantages or disadvantages in the regulation of CRAs methodologies by securities regulators? Please describe the advantages and disadvantages that you consider and which is the best way of dealing with them. Do you believe that this regulation would contribute in some ways to lead to common global standards for CRAs?
   There are no advantages whatsoever in the regulation of CRAs' methodologies, but there are several disadvantages:
   - *By regulating a process, that process is immediately ossified and makes future development and enhancement of the methodology more difficult. It is important that CRAs can adapt their methodologies as circumstances change;*
   - *There is no reason why CRAs should all adhere to one global standard of methodology, and such an aim should be discouraged. Each CRA has its own methodology, just as each CRA has its own opinion on an issuer or on an instrument;*
   - *By regulating a methodology, the regulator is implying an "endorsement" of that methodology and therefore of the rating assessments of that CRA. The IMA believes that all credit ratings are merely opinions and should not be seen to be "sanctioned" by regulators.*
5. Do you believe provisions of the IOSCO Code are sufficient, in terms of rules on CRAs' methodologies and the corresponding disclosure? Do you believe that CRAs should disclose to issuers changes in methodologies before starting to use new methodologies?
   The provisions of the IOSCO Code, while not rules but guidance, are sufficiently robust with respect to measures 1.1 – 1.8 and 3.1 – 3.10 which apply to the quality and disclosure of the rating process. It makes commercial sense for a CRA to disclose to an issuer any change in methodology as part of their ongoing dialogue.
6. Do you believe that regulation should concern all aspects of CRAs' methodologies? How appropriate is the choice of explicitly regulating the four proposed issues (disclosure and explanation of the key elements and assumptions of a rating, indication of some forms of risk warning, rules on updating of ratings and the inclusion of some market indicators within a rating opinion)? Would you deal with these issues by self-regulation?
   Absolutely not. It is totally inappropriate that CRAs' methodologies should be regulated as discussed in Q4 above. Nor is it appropriate to regulate those proposed issues. As ratings are merely opinions and there is a range of

opinions with regard to a specific issuer or instrument at any one time, then regulation will merely serve to drive convergence of opinion. Such regulation would also hinder the development of different business models amongst CRAs. The IMA believes that the IOSCO Code of Conduct Fundamentals provides an adequate set of principles for self-regulation.

Relationship between Issuers and Rating Agencies
Questions

1. Do you consider that the combination of the requirements of the Market Abuse Directive in this area and the requirements of the current version of the IOSCO Code adequately address the issues of access to inside information by CRAs?
   Yes.
2. What is your view on requiring an issuer to itself disclose an imminent rating change where it has been advised of this by a CRA and where the rating announcement may itself amount to inside information in relation to the issuers' financial instrument?
   The change in rating is a matter for the CRA as it is its opinion and so it should be left to the CRA to announce its change of opinion and not to the issuer.
3. Do you consider that the requirements of the Market Abuse Directive in this area sufficiently address the risks that inside information might be disseminated, disclosed, or other misused?
   Yes.
4. Are there any other issues concerning access to inside information which CESR should consider from the perspective of establishing a level playing field between CRAs?
   The IMA believes that more clarity and legal harmonisation are desirable with respect to access to inside information from issuers to rating agencies, particularly given the global nature of many issuers who issue bonds in various currencies and in various regulatory regimes. This would improve comparability for investors across a corporation's debt issues.
5. Are there any other issues concerning the Market Abuse Directive's provisions concerning inside information that you consider to be of relevance to CRAs and their activities which need to be considered?
   No.
6. Do you consider that it would be helpful to have a dedicated regime covering CRAs and their access to inside information?
   See Q 4 above. The general provisions of the Market Abuse Directive as well as the principles 3.11 – 3.18 in the IOSCO Code are sufficient with respect to addressing the issue of inside information.
7. Is this provision sufficient to ensure that issuers have an opportunity to discuss and understand the underlying basis for any rating decision? If not, what other measures do you consider should be introduced?

With respect to the relationship between a CRA and an issuer, the IMA believes that it is desirable that there is a continuing dialogue between the two parties. The CRA should be able to explain the underlying basis to the issuer for its rating decision, while the issuer should be able to correct any factual errors as well as notifying the CRA of any change in its business which may affect the assumptions and fundamental determinants of the rating. CRAs should make public when they last had a meeting with the issuer.

8. In addition to being able to discuss the basis for a rating, should an issuer have a "right of appeal" where they disagree with the CRA's opinion?
   If the issuer disagrees because of factual errors then they should communicate those to the CRA. Otherwise, as a rating is merely an opinion, a "right of appeal" should not apply.
9. Do you consider the provisions of the current draft IOSCO Code and the Market Abuse Directive to be sufficient to ensure that information published by CRAs is accurate?
   Yes. It is not in the commercial interest of a CRA to publish information which is not accurate.
10. Given the lack of specificity in the current draft IOSCO Code to maintain internal records for any particular time period, do you think more specific measures would be appropriate, requiring for example all the information received by a CRA to be kept, along with records supporting its credit opinions, for a minimum of 5 years?
    Five years would appear to be an appropriate period. It is important that information and methodologies be archived, not only that it can be explained to the issuer, but also so that it is available to a new analyst who may not be familiar with the issuer's business or industry.
11. Do you consider that it would be appropriate to introduce measures requiring the establishment of a rating agency data room to ensure that all CRAs had access to the same information concerning a particular issuer?
    The IMA sees a number of practical difficulties with this measure. The cost of establishing this facility may deter companies from accessing European bond markets, as will the possibility that there may be dissemination of materially sensitive information on a wider scale than is commercially desirable. Furthermore, the ability of a CRA to ask the right questions and win credibility with investors for doing this is a key part of their competitive incentive.

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

Questions

1. Could you assess the policy options concerning the need for regulation or other measures, with particular reference to the practical implications for competition in the rating market and for the quality of ratings and of information to the market? In particular:
   - A full registration/regulation regime based upon detailed criteria;
   - A lighter registration/regulation regime essentially based upon the IOSCO Code;
   - To assess compliance to IOSCO Code Fundamentals in a parallel process to CRD's recognition;
   - A third party's certification or enforcement of the IOSOC Code;
   - Relying upon rules covering only specific aspects of CRAs' activity;
   - Monitoring the market developments.

The IMA believes that to impose a registration/regulatory regime on CRAs will impose barriers to entry on the industry, which is an undesirable outcome with regard to fostering competition. More competition in the ratings' process will encourage a higher level of analytical input and thereby improve the quality of ratings overall.

The IMA also believes that regulation of CRAs implies an "endorsement" of ratings which is misleading to investors as to the quality of that rating. As we have noted before a rating is merely an opinion. In addition, by attaching weight to a credit rating by regulation, the more difficult it is for the analyst to change that rating and thereby slowing down opinion forming and information to the market.

2. Could you please indicate your preferred option and highlight pros and cons that you see with regards to each policy option?
   The IMA encourages CESR to resist registration/regulation of CRAs and to allow the industry in Europe to adopt the IOSCO Code of Conduct Fundamentals as its self-regulatory regime. The IOSCO Code provides for transparent and robust practices and allows the CRAs themselves to develop business procedures to deal with the issues raised in this consultation. The Code's principles offer sufficient flexibility to suit different business models as well as allowing for future market developments.
3. Do you think the IOSCO Code of Conduct is conducive to reducing or increasing competition?
   Increasing.
4. Are there any areas where any European rules of conduct should be extended beyond the IOSCO Code?
   No. The IMA believes that the IOSCO Code has the advantage of being globally acceptable, having the flexibility to adapt to different business models as well as allowing for future market developments, and is appropriately robust and transparent.
5. To what extent is a joint treatment of rating agencies by banking and securities regulators desirable?
   Joint treatment is desirable. To have CRAs subject to two different regimes would be too onerous and disproportionate, with no obvious additional benefit to the market place.