

31 March 2008

Reuters response to CESR 'Consultation Paper on the Role of Credit Rating Agencies in Structured Finance' (Ref: CESR/08-036)

Overview

Founded in London in 1851, Reuters is one of the world's leading news and information companies, providing indispensable information tailored to professionals in the financial services, media and corporate markets.

Reuters welcomes the opportunity to provide comments to the CESR consultation on the role of credit rating agencies in structured finance. Since the company's inception over 150 years ago, one of Reuters core services has been to provide information on financial markets to professionals operating in these markets throughout the globe. We supply information from over 160 exchange and OTC markets globally and maintain over 200 million data records.

Over the last 18 months, Reuters research managers have conducted analyses of the market for structured financial products in Europe. They have found that this market exhibits an unusually high degree of opacity, which, they believe, contributed to the sharp reassessment of risk that followed the U.S. subprime crisis.

In Europe, information that is routinely available to investors in other asset classes is not available to investors in structured products. This affects the quality of structured product investment decisions and may encourage excessive risk-taking during periods of easily obtained credit. It is also particularly detrimental to investors' trust and confidence during difficult financial conditions, thereby exacerbating liquidity stresses.

Orderly, transparent and efficient markets rely on the availability of key information. Reuters therefore believes that there is scope for greater disclosure of information on structured products. In the context of the present CESR review, we submit that, while a focus on the role of credit rating agencies (CRAs) is important, there are broader considerations that should be taken into account. This response therefore focuses on the following question in the CESR Consultation Paper:

"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?"

Information on structured products

Structured financial products are, by their nature, complex instruments involving layers of different underlying assets. This makes their analysis a complicated and resource-intensive exercise, which is not a task that is generally feasible for investors to carry out. In this context, as CESR notes, 'the market has come to heavily rely on credit ratings' (Consultation Paper, page 8). While ratings have helped to reduce (though not eliminate) the information asymmetry for investors, concerns have been expressed that there is often an over-reliance on inputs from CRAs.

The predominant model for providing ratings to date has been the 'issuer pays' model. This involves a firm paying a CRA to rate the structured products it intends to issue. The firm

supplies the CRA with the information it requires to give the product a particular rating. Since the ‘issuer pays’ model has been so dominant to date, information on structured products has generally been available only to CRAs and not released more widely.

This situation gives rise to three issues. Firstly, investors do not always have full knowledge of the products in which they are investing (‘information asymmetry’) and are therefore unable to perform their own independent analyses. Secondly, concerns have been raised about the adequacy of traditional, issuer-driven ratings models, particularly over how rapidly CRAs react to market trends. Thirdly, since the information required to form an opinion on a structured product is only available to CRAs, ratings providers other than traditional CRAs are inhibited from entering the market.

Reuters believes that certain information on structured products should be more widely and regularly available and that this would permit the development of new types of ratings that would help to address the three issues identified above.

New types of ratings

If greater information about structured products was more widely available, new types of ratings would become possible. Firstly, this could include ratings based on non-traditional business models, such as a move away from traditional ‘issuer pays’ models to methods that are more market-driven and independent of issuers. This would also give investors and financial institutions the possibility of independently monitoring their structured product investments and/or collateral exposure and the ratings issued for them.

Secondly, new types of ratings that make use of increased data transparency period-by period would also be able to incorporate new types of information within their methodologies. This could include macroeconomic factors, including, for example, revisions to interest rates, which could affect the likelihood of defaults in a particular product and the liquidity of that product.

Greater transparency

More sources of ratings would boost the transparency of structured products and further reduce the information asymmetry for investors. This would help to improve investor confidence and permit investors to make more accurate and independent risk assessments based on more numerous sources of information about the likelihood of default in a particular product. Greater confidence could help to ensure adequate liquidity for particular structured products and avoid sharp downward revisions of the value of such products, as occurred during the U.S. subprime crisis.

Overall, we believe that greater transparency of information, such as performance reports, on structured products would help create an efficient public market for such products, permitting transparent open-market pricing of market risk. Greater transparency would also allow easier regulatory scrutiny of structured products.

While the need for greater transparency around structured products has been recognised by many commentators, the issue is often viewed as related solely to the methodologies and operations of CRAs. We submit that transparency is a broader issue that relates to the nature of the structured products themselves, as well as CRAs.

Information availability

Reuters believes that greater information should be available about structured products both at the time of issue and throughout their lifespan. This information relates to the nature of the asset(s) underlying the structured product and ongoing data indicating the performance of the asset(s).

In the case of residential mortgage-backed securities (RMBS), the required information would include various historic data related to the loan-to-value ratio, the loan balance, payment delinquencies and prepayments over time. The collection and collation of this information would be analogous to the way that corporate accounts or mutual fund data is sourced from firms by data vendors today. We would be happy to discuss further with CESR the types of information needed and the technical modalities of disseminating this information.

These comments are respectfully offered in the hope that they are useful to the CESR review. We would welcome the opportunity to discuss any of the issues raised in our response with CESR or other interested parties.

Contact details

Nick Miller
Government Affairs Executive
Reuters

nick.miller@reuters.com

+44 (0) 207 542 9982

The Reuters Building
30 South Colonnade
Canary Wharf
London
United Kingdom
E14 5EP