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Dear Ms. Bonde,

On behalf of Moody's Investors Service ("**Moody's**"), let me begin by thanking the Committee of European Securities Regulators ("**CESR**") for this opportunity to comment on its advice to the European Commission on the rating agency industry.

Moody's believes that the Code of Conduct Fundamentals ("**Code**" or "**Code of Conduct**") recently published by the International Organisation of Securities Commissions ("**IOSCO**") and endorsed by international capital market participants demonstrates the benefits that can be gained through cooperation and good faith on the part of the industry, market participants and the regulatory authorities. The Code provides a comprehensive framework for rating agency disclosure that will better equip the market to assess CRA reliability. Such an outcome should serve market integrity and investor confidence without unduly increasing the financial or administrative cost of business for rating agencies or users of ratings. Moody's is committed to supporting the IOSCO process and to implementing the Code. Moody's recommends that CESR and the European Commission (the "**Commission**" or "**EC**") observe the implementation of and adherence to the Code by the CRA industry as a whole. Thereafter, the European Commission can make an informed assessment of whether the need exists for additional regulation.

In an effort to provide CESR with constructive feedback on its *Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies: Consultation Paper* ("**Consultation Paper**"), Moody's has organised our response into two sections. In Section I, we explain in greater detail why it is both appropriate and desirable for CESR to recommend to the Commission to adopt a "wait and see" approach

with respect to additional regulation to monitor credit rating agencies (“CRA”). In Section II, we respond to the specific questions asked by CESR.

I have also attached in Annex I, our recently published press release which communicates to the market our intention to implement, enforce, and disclose our compliance with the IOSCO Code of Conduct.

Should you need any further information to assist you in your ongoing deliberations, or should you wish to discuss in greater detail any portion of this response, please do not hesitate to contact me.

Yours sincerely,

/s/ Michael R. Foley

**Michael R. Foley**  
Senior Managing Director, Europe  
**MOODY’S INVESTORS SERVICE, LTD.**

## Section I: Appropriate Regulatory Framework

### 1. Appropriate Regulatory Framework for the Rating Agency Industry in Europe

- 1.1 The "proportionality principle" is one of the fundamental pillars of the European Union. Established Commission precedent recognises three components of the complete proportionality test. The potential impact of regulatory action vis-à-vis the rating agency industry and the European capital market would dictate that CESR applies all three components to any implementing advice.

- Reasonable relation between means and end.
- Balance between benefits and costs.
- Legislative redundancy.

The underlying questions to be answered are: Are the measures necessary? And, can the objective be achieved by any other means that would impose fewer net costs?

- 1.2 Moody's believes that incremental regulation, as contemplated in Options One through Five of the Consultation Paper, is redundant and unnecessarily burdensome for the rating agency industry in the European market. We therefore recommend that CESR advise the European Commission to adopt Option Six of its proposed regulatory alternatives.

*"Maybe after a certain period of time further measures ...could be considered. Additionally, it has to be taken into account that the IOSCO Code and the CRD do include certain requirements for CRAs, thus it could be worth giving those provisions time to be implemented and then make a judgment above whether they are effective enough."*

- 1.2 Our recommendation to the CESR is based on four considerations:

#### a) No market failure identified

Neither CESR, nor any other body, has identified a market failure which would necessitate a regulatory response. While some have argued anecdotally that Enron, Parmalat or Worldcom demonstrate failure on the part of the rating agencies, intensive regulatory scrutiny in these instances demonstrated that rating agencies were misled by companies who intentionally set out to defraud the market. Moreover, statistical analysis of rating agency performance indicates that the unconditional predictive content of ratings remains strong and within historical performance bands.<sup>1</sup>

#### b) Potential costs associated with increased regulation

It is Moody's opinion that prescriptive regulatory criteria or a regulatory licensing regime, such as contemplated in Options One through Five will have two negative consequences:

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<sup>1</sup> See generally, Measuring the Performance of Corporate Bonds, Moody's Special Comment, April 2003; Are Corporate Bond Ratings Procyclical?, Moody's Special Comment, October 2003.

- First, numerous and strict criteria will have the inadvertent effect of limiting the number of entities that will be licensed to operate in the European market. Such an outcome is contrary to the Commission's mandate to CESR.<sup>2</sup> It is also contrary to Moody's vision of a healthy industry structure, in which natural market forces guide competition and in which periodic, verifiable disclosure of ratings performance, as contemplated by the IOSCO Code, protects against potential deterioration in standards that might otherwise occur with greater competition.
- Moody's believes it can satisfy reasonable regulatory criteria that the Commission might mandate as a pre-condition to continuing to operate in the European market. Further, we intend to implement, comply with and demonstrate compliance with the IOSCO Code of Conduct. We are, however, concerned that the monitoring costs associated with demonstrating compliance to multiple authorities on a continuing basis will be costly, burdensome and disproportionate to the regulatory benefit. This is particularly true if a CRA were required to demonstrate compliance to each EU member state in which it has a legal presence, or more so if extended to each of the 25 member states. While Moody's and some of the larger rating agencies may be able to bear this cost, we believe that the costs associated to demonstrating compliance to numerous regulatory authorities would significantly increase burdens in the industry.

**c) Market sentiment supports no incremental regulatory measures**

Market sentiment, as evidenced by written comments to IOSCO, CESR, and as presented at the CESR Open Hearing on 14 January 2005, is broadly supportive of greater transparency rather than formal regulatory mechanisms. Issuers, investors and intermediaries believe that voluntary transparency in process and methodology implemented on a globally consistent manner would address the various concerns that have been voiced over the past several years. Additionally, because rating agencies operate across various jurisdictions, market participants supported a globally consistent and uniform regulatory framework to the industry.

**d) The IOSCO Code should be given time to prove its efficacy**

The Code has been developed by international regulators with input from market participants and the CRA industry. This broad-based, global effort makes implementation a natural priority for the CRA industry. The concerns under study by CESR, as well as a series of other issues, were identified by and addressed in the IOSCO Code of Conduct. As such, incremental substantive regulation would be redundant.<sup>3</sup> Nevertheless, while the IOSCO Code adequately covers the substance of

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<sup>2</sup> Call for Advice, 3.4,

*"Technical Advice Related to Possible Entry Barriers to the Market for the Provision of Credit Ratings:*

- *whether there are any entry barriers to the market for credit ratings arising from regulatory requirements or otherwise and, if so, whether measures could / should be taken to reduce or remove any such barriers."*

<sup>3</sup> The CESR looked at the following substantive topics as areas of potential concern in the rating agency industry:

- a) Rules of conduct, including ancillary services, payments by issuers, unsolicited credit ratings, capital or other interest links;
- b) Fair presentation, including levels of skills of agencies' staff, methodologies used for building credit ratings

the matters under consideration by CESR and the Commission, it may be argued that the enforcement mechanism of the IOSCO is not sufficiently robust.

IOSCO mandates that rating agencies “comply” with the Code or “explain” why they have not. This mechanism provides regulators and market participants with the ability to assess not only the policies, procedures and disclosures of credit rating agencies, but also the more basic question of whether agencies are trustworthy. In effect, the Code creates open conditions for future regulatory actions depending on the sufficiency of CRA implementation. To the extent that CRAs have indicated they support the Code, regulatory actions need not pre-empt this open assessment process, and CRAs should be given the opportunity to demonstrate their support.

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- c) Relationships between issuers and rating agencies, including access to inside information by credit rating agencies.

## Section II: Responses to Specific Questions Asked by CESR

### Part I: Introduction

- 1) Do you agree with the definition of credit rating agencies? If not please state your reasons?

The definition is the same as that of the IOSCO code. In our opinion the term “Credit Rating Agency” as defined by the IOSCO Code and the CESR proposal is too broad:

- ◆ *Those entities whose primary business is the issuance of credit ratings for the purposes of evaluating the credit risk of issuers or debt and debt-like securities; or*

We understand that IOSCO did not intend to include in the definition of “Credit Rating Agency” those entities that derive credit assessments exclusively from statistical analysis of public market or financial statement data. If, however, our understanding of IOSCO’s intent is inaccurate, we would identify two problems with the provision as presently worded:

- a) ***The definition is not functional.*** As drafted, the term “credit rating agency” captures, in addition to capital market CRAs, entities that provide credit scores and trade credit reporting, potentially including governmental entities.<sup>4</sup> We believe that capturing entities other than traditional capital market credit rating agencies is inappropriate because the Fundamental Code clearly contemplates traditional agencies.
  - b) ***The definition, in combination with other provisions of the Draft Fundamental Code, would preclude certain analytical models.*** The steps that should be taken to produce a high-quality traditional credit rating will necessarily be different from the steps that should be taken to produce a high-quality statistical assessment. For example, the Fundamental Code requires CRAs to consider all relevant information available to the CRA.<sup>5</sup> Statistically modelled credit scores often seek to restrict information used to a more limited set of variables.
- 2) Do you agree with the definition of credit ratings? If not please state your reasons.
- Yes.
- 3) Do you agree with the definition of unsolicited ratings? If not please state your reasons.

Based on conversations we have had with numerous market participants, we believe that their key concern is whether the issuer has participated in the rating process (such that the rating opinion has had the benefit of their perspective), and not whether the rating was “initiated” at the request of the issuer. We would note that identifying initiation will not be a meaningful proxy for participation. There are instances when

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<sup>4</sup> Also, in instances where the credit rating is produced by an entity within another entity, it is unclear at what level of the organizational structure the term CRA would be made applicable. We asked IOSCO for greater clarity around the term.

<sup>5</sup> Provision 1.1: “*The CRA should adopt, implement and enforce written procedures and methodologies to ensure that the opinions it disseminates are based on a thorough analysis of all relevant information available to the CRA.*”

an issuer may not have initiated the rating process but will have fully participated in the rating process.

4) Do you think that issuers should disclose rating triggers included in private financial contracts?

In the interest of transparency, and in line with the Market Abuse Directive, issuers should disclose all inside information within the meaning of the Directive. If in the opinion of the issuer and the issuer's securities advisors certain rating triggers – as well as other types of contingent obligations – are construed as such inside information they must be disclosed.

To the best of our knowledge, issuers are currently under no legal or regulatory obligation to provide any non-public information to rating agencies. Most jurisdictions have deemed it appropriate for issuers to provide information about rating triggers and other contingent obligations which could have important financial effects to rating agencies, to the extent that the rating agencies in turn provide their opinions openly and publicly to the market.

Should Moody's be aware of the existence of a rating trigger or other important contingent obligation and believe that it influences the risk profile of the issuer, or its ability to pay off debt in a timely manner, it will be factored into the rating analysis and reflected in the published opinion.

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.

Moody's ratings are independent forward looking opinions on one characteristic of a corporate entity its relative likelihood to repay debt in a timely manner. We appreciate that the adoption of credit ratings for use under securities and banking regulatory regimes has been in response to the perceived utility of ratings in furtherance of certain public policy objectives, including:

- (i) to help manage principal/agent risks in asset management, and
- (ii) to help specify required capital to cover risks in certain regulated institutions.

Nevertheless, Moody's does not encourage any<sup>6</sup> use of ratings in European legislation. For our reasoning as to the potential negative impacts of use of ratings in regulation, please refer to our response to Question 5.

However, should the continued or expanded use of ratings be endorsed, we ask that legislative authorities remain mindful of the rating's ultimate intent: to assess the relative likelihood that a bond will be paid off in a timely manner. Consequently, if ratings are used for means in regulation other than measuring relative default probability of debt issuers or debt issuances, they may not perform appropriately.

Moreover, increased usage should not be the justification for:

- Imposing intrusive regulation including efforts to control the content or timing of expression of rating agencies' independent opinion; or
- Effecting a change in the rating agencies' exposure to civil litigation, which would also necessarily impede rating agencies expression of their independent opinion.

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<sup>6</sup> As the CRD already uses ratings in banking regulation, it is perhaps more appropriate to say that we do not support any further use of ratings in regulation. We would also note that the CRD only contemplates use of ratings as an interim measure, rather than a permanent solution.

## Part II: Competitive Dimension: Registration and Barriers to Entry

- 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?

There are numerous types of credit assessment providers, which compete vigorously for the trust of the market.<sup>7</sup> They include, for example, traditional credit ratings, statistically derived ratings that rely solely on market-based or other financial data, bond research provided by brokerage firms, credit research performed by banks and other financial firms, and trade credit reporting agencies.

While there are numerous types of credit assessment providers, there are only a small number of large traditional rating agencies. Moody's believes that the reason for this concentration lies in the unique dynamics of the credit rating agency industry and several natural barriers to entry.

Traditional credit ratings assist in providing broader marketability for an issuer's bonds. While other credit opinion providers may choose to only provide their ratings on a subscription basis, Moody's and many other credit rating agencies distribute their ratings publicly and free of charge. Public distribution of ratings, however, means that the primary consumers of ratings – institutional investors – do not have to purchase ratings, as they are freely available.

Natural barriers to entry in the traditional credit rating agency industry where ratings are publicly and freely provided are:

- a. **The Costly Nature of Executive Time** – Debt issuers have a limited use for more than a few ratings because fundamental credit analysis, and therefore each agency relationship, requires the issuer's time and executive resource commitments. This includes preparing and presenting information, and maintaining that flow of information and communication on a periodic basis.
- b. **Network Externalities** – Investors desire consistency and comparability in credit opinions. The more widely an agency's ratings are used/accepted by market participants the greater the utility of its ratings to investors, and therefore to issuers.
- c. **Broad Coverage** – Investors place greater value on an agency's ratings the broader its rating coverage and the more widely its ratings are used.
- d. **Track Record** – Investors have more confidence in ratings that are assigned by agencies with publicly established track records of predictive ratings over a period of time. Due to the relatively small number of defaults in the public capital markets, it is difficult to establish track record.

The combination of the public nature of the credit rating and natural barriers to entry account for the fact that only a few traditional rating agencies will be able to operate and thrive on an issuer-pays model. Therefore, it is likely that only a limited number of agencies (though potentially a shifting group) will attain an issuer's business, regardless of the aggregate number of competitors.<sup>8</sup>

Moody's recommends an industry structure guided by natural economic forces, and market-based competition within the industry to promote the objectives of market efficiency, and

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<sup>7</sup> By way of example, under the definition of CRA as contemplated by IOSCO and CESR, there are many CRAs.

<sup>8</sup> This is especially true if assignment of unsolicited ratings is discouraged in the marketplace.



investor protection. The process of recognizing or regulating rating agencies should not increase barriers to competition. In responding to regulatory authorities globally, Moody's has consistently supported eliminating barriers to entry caused by, for example, vague or difficult to achieve recognition standards.

More generally Moody's has always supported competition in the rating agency industry. Increased competition may augment the number and diversity of opinions available to the financial markets; and encourage rating agencies to improve their methodological approach, and better respond to market demands. To the extent that limited competition is perceived to result from the securities regulatory framework regarding rating agencies, Moody's is on record as not opposing the discontinuance of a recognition framework from rating agencies and the removal of ratings from securities regulation.<sup>9</sup>

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?

There is no barrier, *per se*, in the European market which would prohibit an issuer from attaining a Moody's rating should it wish to have a rating. There are, however, certain structural elements, which make ratings a less attractive alternative for some issuers' financing needs than for others.

For example, two categories of issuers repeatedly have told us that acquiring a rating may prove detrimental rather than beneficial for their cost of financing.

a. Powerful and recognizable brand names.

These are issuers who are able to place bonds at competitive yields within their home-countries based primarily on the power of their brand recognition. Such issuers are particularly motivated to avoid ratings if their strong brand recognition favourably diverges from their creditworthiness.

b. Limited size and scope.

Small and medium-sized enterprises, generally referred to as SMEs, have lesser need for large-scale financing. More often than not, such entities prefer to rely on their banks with their comparatively attractive loan rates. Ratings are less relevant to banks, as they conduct their own internal credit analysis.<sup>10</sup>

These categories of issuers perceive that there is little benefit to obtaining ratings. Bank financings also eliminate or reduce, the expenses of securities registration, investment banking fees, rating agency fees, and legal fees and disclosure. So long as issuers have a choice amongst various avenues for accessing competitively priced funds, the benefits of attaining a rating may be outweighed by the costs associated with accessing the capital market.

The rating fee is usually a relatively small component of total costs. However, insofar as fees charged by traditional rating providers are viewed as a hindrance to SMEs ability to access the capital market, Moody's would be very willing to consider means of addressing this concern.

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<sup>9</sup> Moody's Response to the US SEC Concept Release, July 28, 2003.

<sup>10</sup> The Basel accord, which causes low rated entities to receive a higher capital charge than unrated entities, may cause further amplification of this issue.

## Part III: Rules of Conduct

### A. Interests and Conflict of Interest

- 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?

CESR has asked in a number of the Consultation Paper questions whether the policies, procedures or methodologies applied in assigning credit ratings should be disclosed on a rating-by-rating basis. Moody's recommends that disclosure not be required at this level.

Depending on the specific nature of the disclosure, for individual ratings the obligation could prove highly burdensome.<sup>11</sup> It would also necessarily rely on self-assessments by rating analysts or rating committee chairpersons, as the frequency of required disclosures would overwhelm centralized oversight processes. Moody's instead recommends a mechanism that relies primarily on periodic reporting by compliance professionals, not participants in individual rating committees. A centralized monitoring and compliance function is able to consolidate its work and still test processes and practices to a robust confidence level. Not only is this a more efficient and less costly process, we believe it is more powerful. For compliance professionals to operate effectively, processes must operate at a level where they can do their work.

Moody's further recommends that periodic disclosures include a rating agency's performance or track record, and as such will help promote the proper level of reliance on the credit rating agency.

- 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?

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<sup>11</sup> Consider the impact of two scenarios in which CRAs would disclose on a rating-by-rating basis:

#### – Full Disclosure in the Press Release

In each instance that a press release is published announcing a rating change, it would also need to identify the procedural and methodological policies and the extent of their applicability to the rating change. If this were the obligation, the press release document would be modified from a tool that quickly and efficiently communicates pertinent information to the market, to a cumbersome and lengthy document that enumerates and discusses the application of the numerous policies, procedures and methodologies that a CRA may have used in that instance.

#### – Statement of Attestation on Each Press Release

Each press release should include a statement of attestation that all CRA methodologies and policies were followed appropriately. The attestation would be made by the individual rating group that formulated the rating opinion. While Moody's trusts in the integrity of our rating professionals, we would supplant a mechanism that relies primarily on our compliance and internal audit professionals. Independent compliance professionals are better equipped to perform objective assessments, but would be overwhelmed by this level of specificity.

Moody's does not provide advisory or consulting services to issuers.

We believe that providing credit research services and data are an integral part of the traditional rating agency business and are not "ancillary services".

We do provide a Rating Assessment Service (RAS), which we offer as part of our rating services. RAS is a formalization of an activity that has been inherent in the rating process as issuers often ask us "what would happen to our rating if we did X?" Accordingly, the RAS service increases transparency around the rating process and provides useful information that can help companies make informed decisions. RAS is an accommodation to issuers and Moody's charges a separate fee when issuers are considering a complex or significant transaction in a limited time frame and want us to devote significant resources to the assignment. The RAS service is not now, nor is it expected to become, a consequential contributor to our revenue.

In recognition that certain types of situations may present an inappropriate level of conflict for Moody's, we do not offer RAS to issuers if, for example:

1. the issuer is not prepared to deliver a fully developed hypothetical scenario.
2. the scenario involves a merger or acquisition that could be legitimately construed by the acquirer, the target, or the market as "hostile."
3. the company is under review or on Moody's Watchlist for possible near-term rating action.

Moreover, we engage in a case-by-case analysis of each new potential RAS evaluation to identify issues and determine whether the level of conflict presented by the situation can be successfully and effectively mitigated.

Our terms for offering RAS make clear to issuers that RAS determinations may not be the same as the final public rating outcome. Final ratings are always based on the actual facts and circumstances at the time of the rating.

- 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. We refer CESR to the responses Moody's submitted to it on 16 October 2004.

- 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?

Please refer to our responses to Questions 1 and 2 above.

- 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?

Please see generally our response to Question 1 above.

Moody's acknowledges that this potential conflict deserves close scrutiny and must be effectively managed. To foster and demonstrate objectivity Moody's has adopted and

disclosed publicly certain core tenants, which we internally refer to as the Fundamental Principles of Moody's ratings management. Among them are:

- Moody's will not refrain from taking a rating action based on the potential effect of the action on Moody's or an issuer;
- Rating actions will reflect judicious consideration of all circumstances believed to influence an issuer's creditworthiness; and
- Rating decisions are taken by a rating committee and not an individual rating analyst.
- We have a set of policies and procedures require that analysts participating in a committee are fully independent from the company they rate.
- Finally, Moody's does not create investment products, or buy, sell, or recommend securities to our clients, or invest in securities for its own account or those of others.<sup>12</sup> The integrity and objectivity of our rating process is of utmost importance to us.

- 6) In order to deal with issues related to unsolicited ratings, to what extent do you agree that it 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?

Please see generally our response to Question 1 above.

As discussed earlier, Moody's believes that unsolicited ratings may prove a helpful tool for the market. Further, and as was expressed during CESR's Open Hearing, prohibiting unsolicited ratings may create yet another barrier to market entry.

However, we recognize that investors have a legitimate interest in knowing whether the issuer participated in the rating process, as it may at times impact the type of or quality of information available to the CRA. Therefore, we agree with the suggestions made during CESR's Open Hearing that designation of unsolicited ratings be premised not on solicitation but rather on whether the issuer participated in the process.

- 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 investments 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?

Please see generally our response to Question 1 above.

Moody's agrees that CRA's should mitigate and disclose links to affiliates or other significant interests between it and another entity. Such links if unmanaged may have an inappropriate impact on the rating.

## **B. Fair Presentation**

- 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

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<sup>12</sup> Moody's ultimate parent company, Moody's Corporation, has a publicly disclosed stock repurchase programme for Moody's Corporation's New York Stock Exchange listed equity (NYSE: MCO). Moody's Corporation may also, from time to time, invest in short-term securities for Treasury management purposes.

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?

Please see generally our response to Question 1 above.

Moody's has four primary ways of ensuring the quality of our ratings.

- Moody's hires skilled analysts with a diversity of relevant backgrounds;
- Moody's analysts must participate in and complete ongoing professional development programs;
- Moody's employs experts specializing in specialized areas analysis to augment our overall understanding of credits; those areas include individuals with substantial experience in the industries they are covering, as well as in functional areas such as accounting, law, risk transference and corporate governance; and
- Ratings are formulated by an appropriately experienced rating committee, such that the committee provides a check for the analyst.
- Chief Credit Officers – Moody's has several chief credit officers, whose mandates cover either regions or market sectors. The function of the Chief Credit Officer is to promote consistency in application of both methodology and credit practices.

Ratings are not the opinion of one analyst, but rather that of the people who comprise the rating committee. As such, while the background of the individual analysts are relevant, Moody's believes it is also the exchange of views and differing perspectives that creates a robust rating product. Therefore, we do not favour disclosing the skill level of individuals.

We do believe that it is important for Moody's analysts to understand and be able to apply a range of credit skills and tools. Consequently, Moody's has a credit training program in which all analysts must annually participate.

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 assessments?

Over time, the ability to assess the outputs of the rating process will allow the market the ability to distinguish CRAs that provide ratings with high predictive content from those that do not.

3) Do you think that undisclosed methodologies could lead to biased credit ratings or to biased interpretation of credit ratings?

Moody's believes that rating methodologies should be made public. With respect to the methodologies we use:

- Changes in Methodologies - whenever feasible, Moody's will publish any significant change in methodology and ask for market feedback before implementation. We find that by opening our process to public commentary, our final approach is more robust and more reflective of market dynamics.
- Research and analysis team - Separately the ratings research and analysis team conducts studies on, among other things, defaults, ratings transitions, and conditional performance of ratings. It also provides quantitative tools to support the rating process.

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?

Moody's is not averse to requiring disclosure and transparency of methodologies, such as IOSCO's provisions which require that rating agencies circulate when feasible methodologies prior to their usage.

Moody's does not support *any* means of regulating methodological content, whether through regulatory supervision or through an industry code for three primary reasons.

First, if regulation is absolute in form and does not allow for flexibility, rating agencies will be constrained in responding to fast developing situations. Rating agencies are expected to meet basic market needs of timely, public dissemination of opinions on creditworthiness. We therefore must have the ability to respond to unusual or fast-developing situations without necessarily following *all* customary protocols and processes as would be contemplated by rules-based implementation of regulation or codes of conduct.

Second, regulatory mandated methodologies will likely impinge upon independence, and undercut market confidence.<sup>13</sup> Rating agencies would not have the same incentives to compete on the quality of their methodologies, and would instead tend to harmonize their approaches to attain regulatory approval (see our response to Question 5). Such an outcome could have the unintentional effect of commoditizing ratings and lessening the overall quality of rating opinions in the market. We would further note that based on the commentary that CESR received during its request for comment on its mandate from the European Commission, market participants who responded indicated that users of ratings seemed also to favour a principles-based approach.

Third, Moody's believes that rating agencies' regular publication of publicly verifiable measures of their ratings performance is the most effective means of ascertaining whether a rating agency is providing high quality opinions to the market and thus of increasing market confidence. We believe that either regulation or industry codes could encourage rating agencies to publish their performance statistics and make them broadly available to the all market participants and users of ratings.

- 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?

We believe that the IOSCO Code of Conduct and the "comply or explain" mechanism recommended by IOSCO adequately address concerns surrounding CRA methodologies. Moreover, Moody's current practice is to disclose publicly and request comment on significant changes proposed to ratings methodologies and procedures. Therefore, we support IOSCO in this proposed "prior notice" provision if the intent is to enhance the transparency within the rating industry by encouraging dissemination of broad and significant methodological changes prior to their implementation. However, our support is conditioned on clarification of two issues:

- ♦ **Changes in methodology versus applications of existing methodology.** Our ability to support and adhere to a prior notice standard ultimately rests on the definition and application of the phrase, "*changes to their rating methodologies and ratings criteria.*" If the meaning of the phrase is limited to significant changes in methodologies and policies,

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<sup>13</sup> Independence, both from issuers and regulators, is one of the most valued attributes of our ratings – indeed this is evidenced by the fact that CRD utilises "independence" as one of its key criteria.



Moody's believes that it is reasonable and acceptable. However, if it is to be applied to minor modifications or the weight accorded to elements of existing methodologies in each specific circumstance, then prior notice will impede day-to-day rating operations and the timeliness of information released to the market. We could not support this latter interpretation.

- ◆ **Prudential, not rule-based, application.** As we have communicated previously, from time-to-time circumstances will cause prior notice to be infeasible or outweighed by other obligations to the market.<sup>14</sup> As such, we support prior disclosure of significant methodological changes only if it is understood to apply as a general principle, in which exceptions are tolerated in the interest of rating timeliness and investor protection.

- 6) Do you believe that regulation should concern all aspects of CRAs' methodologies. How appropriate is the choice of explicit regulation 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?

Please see our responses above. We believe that regulatory authorities should not mandate analytical methodologies. We also believe that disclosure and market transparency is the best means of ensuring that methodological approaches appropriately evolve with and respond to market dynamics.

### C. Relationship with Issuers

- 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 issue of access to inside information by CRAs?

Yes.

Under current practice, Moody's may incorporate non-public information into credit ratings, so long as: (i) such ratings are disseminated publicly; and (ii) the non-public information itself is not disclosed by the rating agency. Curtailing our confidential discussions with issuers would lead to the dissemination of either less timely or less considered rating opinions, which in turn would likely lead to a greater frequency of rating changes, including rating reversals.<sup>15</sup> A rating system that can only learn of and react to information after it has become public will almost inevitably become a more

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<sup>14</sup> For example, the September 11<sup>th</sup> terrorist attacks on the World Trade Centre had instant credit implications for the airline industry, the property-casualty insurance industry and single-property commercial real estate securitizations, among others. Rigid application of a prior notice period would likely have further unsettled the markets under such conditions.

<sup>15</sup> Rating reversals are defined by Moody's as any rating change which is followed by a rating change in the opposite direction within a year. This occurs very infrequently at present. This is partly a result of the ability of rating agencies to be informed of strategic decisions under consideration by an issuer (e.g., remedial actions being planned to offset the negative credit impact of a debt funded acquisition). Issuers are highly motivated to avoid downgrades in the first place and therefore consider a reversal an indication that they have been subjected to an unnecessarily negative rating action. Investors are similarly intolerant of unnecessary rating reversals because of portfolio governance and performance measures that may result in the liquidation of an issuer's debt securities in the event of a downgrade. Investors wish to avoid liquidating holdings at a loss when the credit rating change proves temporary (e.g., forced sale at a loss when a bond is downgraded from investment grade to speculative grade – or Baa3 to Ba1 – only to have that bond shortly returned to investment grade status).

reactive, volatile system. Rating actions can and often do have an impact on the price of debt instruments or the cost of funding for an issuer. Such unnecessary volatility in ratings would therefore increase the volatility of credit spreads and increase transaction costs for both issuers and investors in the European market, without providing a corresponding benefit.

Moreover, under the Market Abuse Directive, no entity in possession of inside information may trade on that information. CRAs are no exception to this rule. Moody's takes the responsibility of access to inside information very seriously, and has internal rules and policies to promote proper treatment of confidential information.

- 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 instruments?

It is Moody's practice to allow the issuer a short prior notice, typically under an hour, to know of a rating committee decision and to review the press release on its rating prior to that press release's publication. It is our intent that limiting the time period during which the issuer and Moody's have the information of the imminent rating action we also limit the possibility of misuse of the inside information. We ask the issuer to review the PR as a safeguard against inadvertently providing the market with factually inaccurate statements. Requiring the issuer essentially to publish a press release prior to Moody's press release on the rating change will not provide the market with any incremental benefit.

- 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 otherwise misused?

Yes. Please see generally our response to Question 1 above.

- 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?

No.

- 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 governing CRAs and their access to inside information?

No. We believe that the combination of the Market Abuse Directive prohibition against misleading the market and misusing inside information, and the relevant provisions in the IOSCO Code of Conduct Fundamentals adequately addresses all issues around the appropriate treatment 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?

The provision is sufficient.

- 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?



Moody's believes that the rating process should afford the issuer all of the opportunities it needs to provide information it deems necessary or appropriate. An issuer also always has a "right of appeal" if it receives or develops new information reasonably likely to be relevant to the rating committee's thinking. Otherwise, it is Moody's policy that, while it is crucial that issuers understand the reasoning for our rating opinions and have an open channel for communicating new information, it is equally crucial that they not otherwise be able to influence the independence of the process.

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?

Moody's ratings provide predictive opinions on one characteristic of a corporate entity's financial enterprise – its relative likelihood to repay debt in a timely manner. Among other factors, our ratings are primarily based on analysis of companies' financial statements, as well as on assessments of management strategies and industry position. Because of the nature of our analysis, it heavily relies on the quality, completeness and veracity of information available to us, whether such information is disclosed publicly or provided confidentially to Moody's analysts. Moody's role is not now, nor has it ever been, to search for and expose fraud. Consequently, CRAs are not equipped to verify the accuracy of the information they have gathered, either from the issuer or through the market itself. We would suggest that it would be inappropriate to place such a burden on the CRA.

Moreover, while it is crucial that our ratings be reliable in their aggregate probability assessments of credit risk, however desirable, it is impossible for any single opinion to be "accurate" or "inaccurate" on a case-by-case basis.<sup>16</sup> To judge the quality of any opinion about the future, including rating opinions, on such a basis is to place an inordinate burden on the fundamental nature of opinions. We strongly suggest that oversight measures look to promote the trustworthiness of rating opinions in the aggregate rather than on an individual basis.

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.

It is difficult to provide a minimum or maximum range for the information that the rating agency uses in its opinion formation process simply because Moody's is in the business of analyzing many different types of businesses. For example, the types of records used to formulate an opinion on an auto company will necessarily be different than those used to formulate an asset backed security transaction. Moreover, it would be superfluous and unmanageably burdensome to hold on to every piece of paper or item of information that is gathered or attained through the rating process. In designing our own Record Retention Policy, Moody's has put in place a schedule that is specifically tailored for each of its main lines of business and we have identified only those records that are necessary or relevant in our rating process.

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.

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<sup>16</sup> For example, while the vast majority of Baa securities pay off certain Baa securities default. Neither result is "wrong" *per se*. But an issuer with a Baa rating whose bonds do in fact pay off will argue that their securities were rated too low, just as an investor holding the rare defaulted Baa security would argue that the rating was too high.

No.

It will create also the possibility that rating agencies will not ask the probing questions that they otherwise would, as their direct competitors would be present to hear their analytical thought process. Any measure that harmonizes the rating opinions or induces rating agencies to provide similar – if not the same – opinion will prove harmful to the market as it will limit diversity of opinion and potentially increase systemic risk.

#### **Part IV: Regulatory Options Concerning Registration And Rules of Conduct for Credit Rating Agencies**

Please see our discussion in Section I of this response.

## Annex I

### MOODY'S ENDORSES IOSCO CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES

New York, January 24, 2005 -- Moody's Investors Service said that it endorses the Code of Conduct Fundamentals for Credit Rating Agencies recently published by the International Organization of Securities Commissions (IOSCO). Moody's president Raymond W. McDaniel said, "We support the fundamentals developed by IOSCO, and we are taking the steps necessary to implement them." Moody's said that it is currently modifying its June 2003 preliminary Code of Conduct to reflect the final version of the IOSCO Code of Conduct Fundamentals, and that it anticipates publishing its updated Code in March. Moody's said that it will annually report for public review the status of implementation of its Code of Conduct, and will disclose any future modifications or additions.

In December 2004, IOSCO published The Code of Conduct Fundamentals for Credit Rating Agencies. The document was the product of two years of collaborative effort among the credit rating industry, market participants, and global regulatory authorities.

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